INDEX.

	PAGES
Statement	1-13
Order of Commission	2
Commission's Method of "Trending" Value	2
Case presented below	3
No Test Period Needed	4
Stipulations	4
Used General Indices in the Telephone Company's Prior Rate Case in this District Ten Years before	6
Opinion of District Court	8
"Cushion" allowed by Commission	10
Difference in Depreciation Rates allowed by Court and Commission not alone sufficient to determine Confiscation	12
Outline of Argument	13-16
ARGUMENT	17
I. Points now sought to be raised which were not presented below	17-22
Raising Points for First Time in This Court	18
1. Western Electric Prices as Included in Cost of Maintenance	19
2. Maryland Capital Stock Tax	20
3. Labor rates of the Company	22
II. The so-called Practical Result of the Commission's Action	22-24
III. Scope of Judicial Review	24-28

	PAGES
IV. Valuation	29-57
1. The Commission's valuation is an arbitrary amount arrived at by a formula which bears no relation to any logical or sound criteria or method of valuing the property of a public utility. It follows as a corollary to this statement that the Commission's determination of value is thereby shorn of any presumption of validity which the law would otherwise attach to it	31-42
Practical Result of Commission's Methods	43
2. The evidence presented to the District Court by the Commission in support of its valuation has the same infirmity that inheres in the valuation itself	44-47
Commission's Methods would now give value greater than Court's	46
3. The evidence in the record clearly and convincingly sustains the District Court's findings of value	47-50
(a) The Company's Book Costs	47
(b) Cost of Reproduction	48
(c) Going Value	49
(d) Accrued Depreciation	50
4. The Company's Property Used and Useful in its Public Undertaking	51-53
5. Working Capital	53-57
V. Reproduction Cost New	57-82
1. The Company's Methods	60
2. Western Electric Prices	61
3. Telephone Company's Labor Costs	76
4. Undistributed Construction Costs	79
5. Buildings	81

PAGES

VI. Depreciation Annuity or Expense 83-102

The District Court's allowance of $2,000,000 for the expense of depreciation for the year 1934 is amply sustained by the evidence 83

1. The District Court correctly understood and applied the established principles of law 86

2. The finding of the District Court was not arbitrary, as contended by the Commission 88

3. The District Court's finding is fully sustained by the evidence 89

VII. Rate of Return 102-114

1. Principles determining Fair Rate of Return 103

2. Evidence on Rate of Return 106

3. Effect of Depression on Fair Rate of Return 107

4. Evidence of Cost of Raising Capital to Company and to American Telephone and Telegraph Company 110

5. Comparison with other Bell Companies 112

6. Commission's contention that net return should be reduced in proportion to any increase in the value of the dollar in terms of general commodities 113

7. Commission's contention that rates should be reduced because the income of the average telephone subscriber has been reduced 114

Conclusion 115

PAGES

Appendix ..... i-iii

Statement of charges against the Depreciation Reserve Account as a result of the storm of January 23, 1935 iv

Graph of All Commodities Index up to February, 1935 v

Summary tabulation of amounts found by the Commission, the corresponding amounts in the evidence of the Company, and the comparable amounts found by the District Court vi

Table of Cases Cited.

	PAGES
Bluefield Water Co. v. P. S. C. of W. Va., (1923) 262 U. S. 679	103
Brooklyn Borough Gas Co. v. Prendergast, (1926) 16 F. (2d) 615	51
Chapman v. St. Francis Levee District, (1914) 234 U. S. 667	App. i
C. & P. Tel. Co. v. Whitman, (1925) 3 F. (2d) 938	6, 35, 43, 55, 56, 90, 100
Chicago Telephone Case, (1934) 292 U. S. 151	19, 84, 86, 87
Clark's Ferry Bridge Co. v. P. S. C. of Pa., (1934) 291 U. S. 227	28, 86
Columbus Gas & Fuel Co. v. P. U. C. of Ohio, (1934) 292 U. S. 398	52
Crowell v. Benson, (1932) 285 U. S. 22	27
Dayton-Goose Creek Ry. v. U. S., (1924) 263 U. S. 456	103
Denver Union Stock Yard Co. v. U. S., (1932) 57 F. (2d) 735	51, 52
Edward Hines Trustees v. Martin, (1925) 268 U. S. 458	18
Georgia R. & P. Co. v. R. R. Comm. of Ga., (1923) 262 U. S. 625	28
Lincoln v. French, (1882) 105 U. S. 614	26
Lindheimer v. Ill. Bell Tel. Co., (1934) 292 U. S. 151	19, 84, 86, 87
Los Angeles Gas & Elec. Corp. v. R. R. Comm. of Cal., (1933) 289 U. S. 287	12, 52
Mobile, etc., R. R. Co. v. Turnipseed, (1910) 219 U. S. 35	26
Northern Pac. R. Co. v. Dept. of Public Works, (1925) 268 U. S. 39	42
Ohio Valley Water Co. v. Ben Avon Borough, (1920) 253 U. S. 287	26
Potomac Edison Co., Re, Md. P. S. C., (1935) 7 P. U. R. (NS) 135	22

PAGES

San Diego Land & Loan Co. v. Jasper, (1903) 189 U. S. 439 52

Smith v. Ill. Bell Tel. Co., (1930) 282 U. S. 133 ..... 70, 86, 98

Southwestern Bell Tel. Co. v. P. S. C. of Mo., (1923) 262 U. S. 276 104

State Corp Comm. v. Wichita Gas Co., (1934) 290 U. S. 561 28

Susquehanna Power Co. v. Tax Comm., (1931) 283 U. S. 297 21

United Railways v. West, (1930) 280 U. S. 234 ..... 9, 18, 27, 104

West Ohio Gas Co. v. P. U. C. of Ohio, (1935) 55 S. Ct. 316 ..... 19, 22, 53

Western & Atlantic R. R. v. Henderson, (1929) 279 U. S. 639 26

Statutes.

Federal:

Revenue Act of 1934, Sec. 23, Subsec. d 22

Maryland:

Bagby's Maryland Code, Annotated, 1929 Supplement:

Article 81, Section 15 ..... 20, 21

Books.

Dickenson, John, Administrative Justice and the Supremacy of the Law 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1934.

No. 648.

HAROLD E. WEST, J. FRANK HARPER AND STEUART PURCELL, CONSTITUTING THE PUBLIC SERVICE COMMISSION OF MARYLAND,

Appellants,

vs.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF BALTIMORE CITY,

Appellee.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF MARYLAND.

BRIEF FOR APPELLEE.

STATEMENT.

This being a confiscation case necessarily involves questions as to (1) the present fair value of the Company's property, (2) its expenses and (3) rate of return. These main questions are argued under points IV-VII inclusive of this brief. There are certain subsidiary questions raised in the Commission's brief which we think should be noticed. These are dealt with in this brief preliminarily to the main argument and are found under the first three points in our argument.

We are submitting the following brief statement principally for the purpose of negativing some of the implications or inferences suggested in the statement of the Appellants.

Order of Commission.

By its original order, the enforcement of which was sought to be enjoined by the suit below, the Commission ordered the Telephone Company to submit amended schedules of rates, to become effective January 1, 19[illegible], by which a reduction of approximately $1,200,000. in the gross annual revenues of the Company would be made; the Commission's opinion, which was made a part of its order, finding that a reduction of $1,000,000. in the Company's net revenues should be made; and that a reduction of $1,200,000. in gross revenues would accomplish this result (I, 78, 17).

This order made no distinction between intrastate and interstate gross or net revenues; and was therefore possibly susceptible of two interpretations. Any such questions however were removed by a stipulation of the parties made during the course of the trial, in pursuance of which a *nunc pro tunc* order was entered by the Commission fixing the amount of reduction ordered as a reduction of not less than $850,000. in the net annual revenues of the Company from its intrastate business (I, 81); and the case therefore proceeded on the agreed basis that this was the intent and operation of the orde[illegible] sought to be enjoined.

Commission's Method of "Trending" Value.

As fully shown by the opinion of the Commission (I, 13, etc.), as well as by the testimony presented in the case in Court, the findings of the Commission as to present value were arrived at by "trending" the value of

the Company's property from a valuation which had been found by a three-Judge Court in a case ten years earlier, and from the cost of subsequent net additions, by applying to such initial costs the ratios derived from an index of values constructed by the Commission by combining in certain arbitrary proportions the curves or indices of general commodity prices and other general indices. The Commission, as it expresses it, "trended" these earlier values so as to give effect to what it called the change in the purchasing power of the dollar, and thereby arrived at a present value, for rate-making purposes, of the Company's property, without the necessity for considering the present value of the particular classes of property of which the Company's [illegible]ting plant consists.

Case Presented Below.

As it is intimated at several places in the Commission's brief that the three-Judge Court which heard this case below did not have or allow sufficient time for the hearing of the case to enable it to consider the questions involved with the fullness with which the Commission is supposed to have considered them, some attention should be directed to this supposed point.

In the first place, it should be noted that the somewhat unusual terms of the order of the Commission facilitated a hearing in court and obviated the necessity for considerable detailed and technical proof, which would have been otherwise required. If the Commission's order had taken the form of prescribing a schedule of rates, then elaborate testimony would have been required to show what the probable results of such new rates would be, in determining the probable net earnings of the Company therefrom, in the near future; and what the amount of the consequent loss in gross and net rev-

enues to the Company would be from the operation of such new rates. But the form, or rather substance, of the Commission's order, together with the stipulation (I, 100), dispensed with any necessity for such evidence; because the order specifically directed a cut or reduction of not less than $850,000. in the net revenues of the Company derived from its intrastate business (I, 81).

No Test Period Needed.

The suggestion is made in Commission's brief that the Company should have waited for a test period on the new rates. But the purpose of such a test period, when necessary, is to demonstrate what the effect of new rates upon the revenue of the Company will be. The form of the Commission's order in the present case, together with the stipulation that the reduction directed "shall be deemed to be a reduction of $850,000. per annum in the net revenues of the Plaintiff under its existing rates and charges from its intrastate operations and business" for all services rendered after January 1, 1934 (I, 81, 98), were sufficient to make any such test period unnecessary; because, *ex hypothesi*, the net rates were to be such as would produce the stated reduction in the Company's net revenue. The only effect of a test period therefore would be to show what the immediate future might bring forth; and at the end of any such test period the Company would be confronted with an equal uncertainty as to what the then immediate future would produce.

Stipulations.

The Court hearing was further facilitated by stipulations of the parties, obviating the need for other voluminous and technical evidence. The ratio of the Company's intra and interstate property, revenues and expenses was

agreed upon as 85% intrastate and 15% interstate (I, 98); thus avoiding the necessity for very complex proofs and calculations; and also making it possible to work out the question of confiscation either by using the total valuation, revenue and expenses of the Company, or by using 85% of each part thereof, as the intrastate portion, with the same result. Besides the parties arrived at a stipulation as to the value of all of the lands and part of the buildings (I, 95);—the Commission's faith in its index method being however so great that it qualified its stipulation by the proviso that the stipulation should not prevent it from showing that the "trended value" of the land, according to its index method, rather than its actual present value as stipulated, should be the basis of valuation. Stipulations were also made as to the propriety of the annual payments to the American Telephone & Telegraph Company under the License Contract and the annual accruals for pension funds (I, 95); all of which of course tended to narrow the field of proof.

Nearly all of the evidence to be offered by either of the parties, moreover, had been already gone into in the protracted hearing before the Commission; and only required to be brought up to date for submission to the Court. It was nearly all presented in tabular and written form, with abundant opportunity to the witnesses to explain each exhibit fully to the Court; there were no objections to testimony, and each party had all of the opportunity that it desired to submit evidence to the Court during the twelve days occupied by the hearing before the three Judges below.

Hence the suggestion that there was any haste in the hearing, or that the Judges did not have time and opportunity to consider the testimony fully during the period of a month and a half from the hearing to the decision of the case, is without any foundation. It is per-

haps most fully answered by the following consideration: The case had been set for hearing on the application for interlocutory injunction (Commission's brief is of course in error when it says (p. 2) that a "temporary injunction" was granted upon the filing of the bill;—what was then granted was a restraining order and it was only granted after a summary hearing on affidavits at which the Commission was represented), and at the close of the hearing both parties were so well satisfied that their respective cases had been fully and adequately presented to the Court, that they then voluntarily entered into a stipulation (I, 527) that the case was submitted upon such evidence and upon such hearing, for final decree, as well as upon the motion for interlocutory injunction.

Yet the Commission in its brief (p. 103) refers to the trial below as a "hurried hearing of two weeks" and (p. 2) says that the case was heard by the statutory Court "without reference to a master". It may not be out of place to note, in passing, that it is the custom in this District to refer cases to Masters only when necessary; upon the supposition that it is better for the witnesses to testify in the presence of the Judges, as being the preferential mode indicated by the equity rules which have now been in force for many years. All three of the Judges heard every word of the testimony in the hearing of this case below.

Use of General Indices in the Telephone Company's Prior Rate Case in This District Ten Years Before.

As much stress is laid upon the fact that the all commodities index was used in the 1923 rate case of the Company (3 F. (2d) 938), with the implication that the Company was responsible for such use at that time, a brief explanation of the purpose for which it was there introduced, as shown by the opinion in such former case, and

by the opinion in the present case (Circuit Judge Soper, who sat in the former case, being also one of the three Judges who decided the present case below), may not be out of place.

In such former case, the Company offered evidence of the reproduction cost of its property, at a figure much higher than the cost or book value. In general corroboration of this (I, 381), it had offered through Dr. Hollander, Professor of Political Economy at the Johns Hopkins University, evidence to show that there had been a rise in prices generally; including in such evidence the "all commodities" index. This evidence however was distinctly not offered as evidence of the value of the property; but only in general corroboration. It is true that the Court in that case based its finding of value upon the use of this general commodity index; a method of determining the fair value not found in any previous case, and not followed in any case since. The charge is made or suggested that the Company acquiesced in this, as well as that it acquiesced in the finding of six per cent as the minimum rate of return by the Court in that case.

This is only true to the following extent: The decree in that case being in favor of the Company and granting it an injunction against the rates then sought to be enforced by the Commission, it could not of course have appealed. All that it did was not to institute a new court rate case when the Commision allowed rate increases to something above the amount which the Court had indicated as the limit of confiscation, and to make no further application for a rate increase during the subsequent period while business was improving.

To say that this amounted to an acquiescence in the general index method of determining the present value, or amounted to an acquiescence in any of the other particular findings of the Statutory Court, is a statement

without meaning. All that the Company did was to "acquiesce", in the sense of not again appealing to a statutory court for an injunction, in the schedule of rates approved by the Commission, as being in general somewhat better than what the Statutory Court had indicated in its findings to be the limit of confiscation. This is not an acquiescence in any of the particular findings of the then Statutory Court;—still less is it an adoption of the reasoning by which the Statutory Court arrived at its conclusion.

Opinion of District Court.

The evidence before it was considered quite fully and the conclusions and findings of the Court announced in a carefully written opinion (I, 529, etc.). As not unusually happens, the Court found a valuation and other figures intermediate between the contentions of the two parties.

For the value of the Company's property, the Court rejected the general index method which had been used by the Commission, and which was relied on in argument as if it had the force of an estoppel on account of such use as was made of it in the previous rate case ten years before. The reproduction value set up in the Company's proof was scaled and reduced in a number of respects and found by the Court when so reduced to now approximately equal the cost or book value. For this reason, and also for historical reasons which are set forth with much clearness in the opinion, the Court held that the best measure of present fair value was that arrived at by deducting from cost or book value the amount to the credit of the Company's depreciation reserve; and finding the difference (plus a moderate allowance for working capital), without any specific allowance for going value, to be the rate base.

The Commission urges, at various places in its brief, that the Court adopted or "embraced" the prudent investment theory; although under the decisions of this Court fair value and not prudent investment is the standard. Such a statement is grossly unfair to the Court, whose opinion in no respect adopts the so-called prudent investment theory as a basis. What it starts out to find and what it does find is the present fair value of the property of the Company used and useful in its public undertaking; and only under the special facts and circumstances of this particular case, it finds cost less the amount to the credit of the depreciation reserve to be the consideration to which special weight should be given in the present case; its conclusions being, as we have said, supported by its finding that reproduction value would be not less than such cost in the present case.

So, too, as to the depreciation allowance, the Court found for it a figure intermediate between the amounts claimed by the two parties. The Court did not make the mistake which is attributed to it by the Commission in its brief (p. 12) of assuming that the smaller of the Commission's two allowances for depreciation expense was figured on the depreciated value of the Company's property.

What the Commission did was to first reduce the Company's depreciation allowance, on a cost basis, to $1,720,724. (I, 574; II, 921). By computation it found this was 3.45% of the cost of the Company's total fixed capital. In reliance upon the decision in *United Railways Co. v. West*, 280 U. S. 234, it then proceeded to apply the percentage 3.45% to the "undepreciated value" it had assigned to the Company's property by application of its composite index of commodities, etc.; in effect, therefore, it "trended" the depreciation allowance in the same proportion in which it trended the value, thus

arriving at its second figure of $1,352,284. (I, 70, 574). When therefore, in the opinion in the present case, the Court says, in its discussion of the deduction to be made for annual depreciation (I, 574; 7 F. Supp., p. 235) referring to the Commission's alternative allowance of $1,352,284., that "this computation was the result of calculating depreciation expense on the reduced valuation of $32,610,327.", it is perfectly manifest that what the Court meant was that the Commission found its second or alternative and smaller depreciation allowance by applying its percentage result to the "reduced" valuation of the property found by the Commission by the use of its general indices; and not that the Commission was making the further mistake of figuring depreciation allowance on value less depreciation. Nor is this any the less clear because the Court made the purely mechanical mistake of inserting at the end of the sentence the amount which was the Commission's finding of depreciated value instead of its finding of present undepreciated value. As the Court rejected the Commission's valuation, it necessarily followed that it rejected its alternative figure for depreciation allowance; irrespective of whether or not the Commission was right in its finding that $1,720,724. was a sufficient depreciation allowance based on cost.

"Cushion" Allowed by Commission.

Much is said at various points in Commission's brief (pp. 10, 11, 14, 21, 61, 167) about the Court's having ignored the generosity of the Commission in not cutting the Company's net earnings by a cushion of $396,522. over and above the million dollar cut ordered. But this supposed generosity depends altogether on the correctness of the Commission in its figures and findings; and the Court properly approached the case from the objec-

tive standpoint of applying the test of confiscation to the valuation and to the figures which it considered to be proved by the evidence in the case before it. Moreover it should be noted that the Commission was not influenced solely by generosity in not making this further cut. It says itself, in its opinion (I, 17) that it abstained from so doing because of the generally unsettled condition of business and because the All Commodities Index up to September (apparently the latest date then available) indicated that there had already been a rise in prices to the extent of 13.1% since the end of the previous year, to which date calculations based on the indices used by the Commission had been directed.

A simple calculation from the figures in the Record shows that this 13.1% rise in the All Commodities Index since the date as of which the Commission determined present values by the use of its composite index (and by a coincidence the All Commodities Index stood at its same figure on January 1, 1934 (Ex. D-5, p. 71; II, 871), the date when the Commission's order for reduced rates was made effective) would have operated to increase present value if determined by its use (and the rise in the weighted composite index used by the Commission is greater than the rise in the All Commodities Index), by an amount considerably in excess of the "cushion" of $396,522., thus:

Rate base as determined by Commission by use of general index method (I, 76)	$32,621,190.
Return of 6% thereon (I, 76)	1,957,271.
13.1% increase thereon	256,402.
Resulting increase in Commission's depreciation allowance which would increase pro rata with any increase in value	$177,149.

Less decrease in Fed. Inc. Tax	24,358.	
Difference, being net increase in operating expenses		152,791.
Total "cushion" required to offset 13.1% rise in value		409,193.

Hence the "cushion" allowed by the Commission was insufficient to provide for its stated purpose of offsetting the rise in index figures which had occurred up to September 1, 1933, or to January 1, 1934, the effective date of its order; still less was it sufficient to cover the further rise thereafter which the Commission anticipated and which did occur. This means that upon the Commission's own figures and by its own method of determining the value, the reduction in revenue which it ordered would *not* afford the Company a six per cent return; and would therefore be confiscatory according to the Commission's own methods.

The foregoing brief calculations are from evidence in the Record. This Court has heretofore taken judicial notice of the All Commodities index figures compiled and issued by the U. S. Department of Labor, used therein (*Los Angeles Gas & Electric Co. v. R. R. Comm.*, 289 U. S. 287, at pp. 308-309). The latest monthly figure now published is for February, 1935, when it shows a figure amounting to 127% of what it stood at in December, 1932, the time to which all values were trended by the Commission. (See graph in Appendix p. v.)

Difference in Depreciation Rates Allowed by Court and Commission Not Alone Sufficient to Determine Confiscation.

It is further suggested at several points in the Commission's brief (pp. 26-27, 15, 17) that the difference between the depreciation allowance found by the Court

and that found by the Commission would alone be enough, giving effect to the other findings of the Court, to prevent the reduction ordered by the Commission from being confiscatory. This can mean nothing unless it means that such would be the result although the valuation found by the Commission were rejected, and the valuation found by the Court adopted as the basis for return; and Commission's brief expressly so states, in italics (p. 15). But as we have seen the Commission's alternative or lower depreciation allowance of $1,352,284. was arrived at by scaling or trending its depreciation allowance as first found on a cost basis ($1,720,724.), so as to reduce it to the basis of the present fair value of the Company's property as arrived at by the Commission by the use of its general index method. The statements in Commission's brief that such difference in the depreciation allowance is alone sufficient to cover the limit of confiscation, adopting the Court's other findings, manifestly begs the question by assuming that the Commission's valuation and not that of the Court, is correct.

Tabulation of Figures.

For convenience of reference we are including in the Appendix (p. VI) tables showing the amounts found by the Commission, the corresponding amounts in the Company's evidence, and the comparable amounts found by the Court in its opinion and findings of fact.

OUTLINE OF ARGUMENT.

We propose, in our argument, to first dispose of some questions now sought to be raised by the Commission in its brief, but which were not raised, and were in fact conceded, in the hearing of the case below; and next to answer the contention which the Commission presents under the heading of "The Practical Result of the Com-

mission's Action" (p. 25, &c.); and then to take up successively, under the following headings, the Commission's contentions on which it bases its claims that the District Court erred:

		Pages.
I.	Points now sought to be raised which were not presented below	17-22
	Raising points for first time in this Court	18
	1. Western Electric prices as included in cost of maintenance	19
	2. Maryland capital stock tax	20
	3. Labor rates of the Company	22
II.	The so-called practical result of the Commission's action	22-24
III.	Scope of judicial review	24-28
IV.	Valuation	31-57
	1. The Commission's valuation is an arbitrary amount arrived at by a formula which bears no relation to any logical or sound criteria or method of valuing the property of a public utility. It follows as a corollary to this statement that the Commission's determination of value is thereby shorn of any presumption of validity which the law would otherwise attach to it	31-44
	Practical result of Commission's methods	43
	2. The evidence presented to the District Court by the Commission in support of its valuation has the same infirmity that inheres in the valuation itself	44-47
	Commission's methods would now give value greater than Court's	46

	PAGES
3. The evidence in the record clearly and convincingly sustains the District Court's findings of value	47-50
(a) The Company's book costs	47
(b) Cost of reproduction	48
(c) Going value	49
(d) Accrued depreciation	50
4. The Company's property used and useful in its public undertaking	51-53
5. Working capital	53-57
V. Reproduction cost new	57-82
1. The Company's methods	60
2. Western Electric prices	61
3. Telephone Company's labor costs	76
4. Undistributed construction costs	79
5. Buildings	81
VI. Depreciation annuity or expense. The District Court's allowance of $2,000,000 for the expense of depreciation for the year 1934 is amply sustained by the evidence	83-102
	83
1. The District Court correctly understood and applied the established principles of law	86
2. The finding of the District Court was not arbitrary, as contended by the Commission	88
3. The District Court's finding is fully sustained by the evidence	89

		PAGES
VII.	Rate of return	103-114
	1. Principles determining fair rate of return	103
	2. Evidence on rate of return	106
	3. Effect of depression on fair rate of return	107
	4. Evidence of cost of raising capital to Company and to American Telephone and Telegraph Company	110
	5. Comparison with other Bell Companies	112
	6. Commission's contention that net return should be reduced in proportion to any increase in the value of the dollar in terms of general commodities	113
	7. Commission's contention that rates should be reduced because the income of the average telephone subscriber has been reduced	114

ARGUMENT.

I.

POINTS NOW SOUGHT TO BE RAISED WHICH WERE NOT PRESENTED BELOW.

Under the heading of "The Commission's Liberal Allowance of Operating Expenses", the Commission in its brief seeks to now raise and urge several points which were not only not raised in the hearing below, but were practically conceded. These points are raised in the ingenious form of a claim that the lower Court, in passing upon the question of confiscation, should have taken into account the liberality or generosity of the Commission, in not raising such points or questions, either in its own opinion filed in justification of the reduction ordered, or in the hearing before the three-Judge Court below.

The points so sought to be raised include the following:

1. That the Commission did not question the amount of the payments to the Western Electric Company which were included in the Company's annual cost of maintenance (Commission's brief p. 80),

2. That the Commission allowed as part of such operating expenses the full amount of taxes paid by the Company, although such taxes included Maryland tax imposed in the form of a tax on the stockholders (Commission's brief p. 83),

3. That no objection was made to the labor rates of the Company, as included in its cost of annual maintenance, although the evidence showed the average rate of wages paid by the Company was now higher than before the depression (Commission's brief, p. 86).

Raising Points for First Time in This Court.

The Commission is therefore now seeking to raise in this Court for the first time questions as to which no issue was made in the Court below and as to which there is no sufficient evidence in the record, from which such issues could be determined by this Court, even if the same could now be so raised.

It is the established doctrine of this Court that such questions will not be entertained or considered.

In *Edward Hines Trustees v. Martin*, 268 U. S. 458, it was said at page 465:

> "This Court is a court of review and it will not consider questions not raised or disclosed by the record brought to it for a review and which were not considered by the Courts below. McClellan v. Carland, 217 U. S. 268, 283; Bass, etc., Ltd. v. Tax Commission, 266 U. S. 271, 285. And see Davis v. Currie, 266 U. S. 182; and United States Fidelity and Guaranty Co. v. Woolridge, Ante. p. 234."

In *United Railways v. West*, 280 U. S. 234, it was said at page 248:

> "The present value of the property used was fixed by the Commission at $75,000,000, and this amount was accepted without question by both parties in the state circuit court and in the court of appeals. Included in this valuation is $5,000,000. for easements in the streets of Baltimore. The court of appeals had held in another and earlier case, Miles v. Public Service Commission, 151 Md. 337, that the easements constituted an interest in real estate and that in making up the rate base their value should be included. The commission in the present case, accordingly included the amount in the valuation and made no attack upon the item in the courts below, where it passed as a matter not in dispute. The item is now challenged by counsel for the commission in this Court, and other objections to the valu-

ation are suggested, likewise for the first time. We do not find it necessary to consider this challenge or these objections, for, if they ever possessed substance, they come too late."

The principle made clear in the foregoing quotations, was again enunciated and applied in the very recent case of *West Ohio Gas Co. v. P. U. C. Ohio*, January 7, 1935, 55 S. Ct. 316, 319, 320.

Even, however, if these questions, now sought to be injected into the hearing of this case on appeal, had been raised and presented below; yet the evidence in the record in no respect sustains the contention that the Commission was liberal or generous in failing to raise them. We will, therefore, consider each of them, briefly, under this first heading of our brief, before taking up the other points under which we are considering the present case.

1. Western Electric Prices as Included in Cost of Maintenance.

As stated in the opinion of the lower Court (1, 567; 7 F. Supp. 232), no such contention was made in the hearing of this case below; as is in fact admitted by the Commission in its brief here where it says that: " . . . the Commission is not now contending that the operating expenses as estimated for the year 1934" (the trial year on which the computations of both sides were based in the hearing below) "should be adjusted and reduced because of such advances"; but that the point is raised "as illustrative of the liberality of the Commission, and particularly because confiscation is now the issue" (as if confiscation had not been the issue in the hearing below). (Commission's brief p. 81). The attempt is then made to show, not from data from the record in the present case but by inferences sought to be drawn from alleged facts in the *Chicago Telephone case* (292 U. S.

151), that such point, if raised, might have had an appreciable effect on the allowable operating expenses of the Company for the year in question.

We are not here discussing the question of the fairness of Western Electric prices but postponing such discussion to that heading of this brief which deals with the Company's evidence of reproduction cost new (Point V—pp. 61-76).

2. Maryland Capital Stock Tax.

The further point is made in the brief for the Commission (p. 83) that the Commission allowed as operating expenses the full amount of state and local taxes paid by the Company, although these included the so-called tax on capital stock imposed by Section 15 of Article 81 of the Maryland Code of Public General Laws. The answers to this suggestion are obvious.

In the first place, not only was no such point raised below, but the evidence adduced made no such distinction in the taxes paid by the Company out of its operating expenses. In both the exhibits offered for the Company and in the exhibits offered by the Commission, the proof was of the amount, each year, of "taxes assignable to operations" or "operating taxes" under the classification adopted by the Interstate Commerce Commission and by the Public Service Commission of Maryland (Company's Exhibits A-5, A-6 and A-43; I, 611, 613, and II, 797; Commission's Exhibits D-11, II, 882; D-14, II, 921).

In the second place it is clear that if any such point had been raised, and the necessary evidence introduced to sustain it, the point would not have been well founded. While called a tax on capital stock, the tax in question is, under the decision of the Court of Appeals of Maryland and under the decision of this Court in the Susquehanna Power Company case affirming the Maryland Court of

Appeals, in substance and effect a tax on the personal property of the corporation; and its constitutionality was sustained by both the Maryland Appellate Court and by this Court upon the ground that it constituted an indirect tax on the personal property of the corporation (*Susquehanna Power Co. v. Tax Commission*, 283 U. S. 297).

That this is the true nature of the tax is sufficiently apparent by even a cursory consideration of the provisions of Section 15 of Article 81 of the Maryland Code, imposing it; which provides that in no event shall the assessment levied thereunder be less than the fair aggregate value of all of the tangible property of the corporation less the valuation of its real estate; and that the corporation shall be required to itself pay the tax so levied "as if such corporation were the ultimate taxpayer."

Manifestly, such a tax on the stockholders (apart from the question of their residence, the entire tax being collected from the Company in Maryland irrespective of whether the stockholders are residents of that State or not), ascertained in this manner without any real regard to the actual value of their shares, would, as argued in the Susquehanna Power Case, necessarily have been held to be unconstitutional, except for the consideration on which the constitutionality of the taxation was upheld, that it was in substance a tax on the tangible personal property of the corporation, which was not otherwise taxed for the express reason that it was reached in this manner.

In the third place, the Maryland Public Service Commission has recognized this fact and consistently allowed such taxes as an operating expense; not only in this case but in all previous rate cases before it. They have again allowed it in the case of the Potomac Edison Company since their appeal was taken in the present case (Opinion

of Commission in *Potomac Edison Co.* Case 3074, filed Jan. 4th, 1935, 7 P. U. R. (N. S.) 135, 152.

It might be added, moreover, that the government recognizes, for income tax purposes, this and similar taxes as being taxes on the corporation which it may deduct in its return, and not taxes on the stockholders which they may deduct in their individual returns (Revenue Act of 1934, Sec. 23, Subsec. (d), and previous Revenue Acts).

3. Labor Rates of the Company.

The Commission's brief itself says (p. 86) that "At the hearing below, the Commission did not question the wage rates, nor does it do so now". This solemn admission, however, is followed by the statement that as the Commission is now charged with confiscation, it is proper to show that it has "treated the Company liberally by allowing expenses which might legally have been disallowed" (p. 86).

This question is one of those as to which this Court said that, in the absence of a showing of inefficiency or improvidence, good faith is to be presumed on the part of the managers of a business (*West Ohio Gas Co. v. P. U. C., Ohio*, January 7, 1935, 55 S. Ct. 316, 321).

We reserve any discussion of the rate of wages paid by the Company to that part of our brief where we discuss the Company's evidence of reproduction cost new of its property (Point V—pp. 76-79).

II.

THE SO-CALLED PRACTICAL RESULT OF THE COMMISSION'S ACTION.

Under this heading of the Commission's brief (p. 25, &c.) two arguments are advanced.

The first is a repetition of the claim that the case can be decided upon the single item of allowance for depre-

ciation expense, even if the valuation arrived at by the District Court should not be disturbed. We have already dealt with this contention in the statement at the beginning of this brief (p. 12) and shown that the alternative or lower depreciation allowance of $1,352,284., involved in the calculation, itself assumes and is dependent upon the Commission's findings of value by the use of its general index methods.

The second claim made under this heading of the Commission's brief (p. 27) is that, as a practical matter, the net return allowed by the Commission is sufficient to enable the Company to pay interest on its obligations, dividends and other charges, and provide an additional amount for surplus.

This argument, of course, assumes to consider the question from the purely objective standpoint of what this particular Company, with its existing set-up of debts and outstanding stock, would be able to do under the Commission's order; and in assuming a 6% dividend on the Company's outstanding stock, ignores the question of any return upon the Company's existing surplus which is invested in the Company's business and upon which, as well as upon the par value of their stock, the stockholders are entitled to a return.

Ignoring these considerations, however, the statement that the Company, with the net return which would be left to it under the Commission's order, would have sufficient earnings to maintain payment of dividends upon its common stock at 6%, with something over for surplus, *assumes the correctness of the Commission's findings*, because it assumes that the adequate allowance for depreciation would be the reduced or alternative allowance found by the Commission; which, as we have seen, in turn assumes the correctness of the Commission's valuation of the property arrived at by the use of the Commission's general index method.

Moreover even if the Commission's valuation were right it would not follow, as a practical result (and the argument here advanced deals solely with such practical results), that the Company would be able to maintain dividends, &c., as stated, out of the earnings which it would receive. This is so because, whether or not for confiscation purposes depreciation allowance should be computed with reference to present value rather than cost, and whether or not the Commission's finding of present value is correct; it is nevertheless true that the Company is required by law to keep its accounts in accordance with the uniform system of accounts enforced by the Federal Government and approved by the Maryland Public Service Commission.

It will, therefore be compelled to set up depreciation allowance in its accounting on a cost basis (as it has always done), and not on a present value basis. (The Commission says in reference to this, in its opinion, (I, 64-65) that "if, as a result of this, the Company finds itself in trouble with the Interstate Commerce Commission, it will have to adjust such trouble as best it may.")

If therefore the Company were to undertake to distribute, in the form of dividends, the illusory amount of net earnings which the Commission professes to allow it, it would be necessarily declaring such dividends, in part, out of its capital, and not out of its actual earnings available for such purpose.

III.

SCOPE OF JUDICIAL REVIEW.

The argument advanced on behalf of the Commission at the hearing below, was, as summarized in the Court's opinion (I, 562; 7 F. Supp. 230), that "the court may not disturb the Commission's valuation unless the Company has proved *beyond a reasonable doubt* 'that the Commission has been wrong to such an extreme degree

that in the light of all present circumstances, no reasonable body of men could have reached such a conclusion' ".

Substantially the same claim is advanced by the Commission in the argument in its brief on this appeal (pp. 40, 78).

It is to this argument that the opinion below replies that "the law is otherwise", and that "On the issue of confiscation the Court must exercise its own independent judgment of law and fact".

At the same time the lower Court gave full effect to the burden of proof resting upon the Company, saying at the beginning of its discussion (I, 532; 7 Fed. Supp. 217):

> " 'Furthermore it is clear that this court does not sit as a board of revision but only to enforce constitutional rights.' The only question here is whether the rates fixed by the Commission are confiscatory. Upon that question the complainant has the burden of proof and the court should not 'interfere with the exercise of the state's authority, unless confiscation is clearly established' (citing cases)".

Again, in that part of the opinion dealing with the Commission's findings as to a proper allowance for depreciation expense, the Court again says (I, 575; 7 Fed. Supp. 235)—

> "As the issue in the case is confiscation, the burden of proof is on the Company to convincingly demonstrate the necessity for the larger allowance from revenues for depreciation expense than that allowed by the Commission".

The argument of the Commission confuses the question of the scope of judicial review with that of the burden of proof. Although the burden of proof on the issue of confiscation rests on the Company, nevertheless in a judicial determination of that issue the Court was

required to exercise its own independent judgment as to both law and facts.[1]

Equity Rule 70½ requires the court of first instance, including courts constituted of three judges, as in the present case, to find the facts specially and state separately its conclusions of law thereon, the findings and conclusions to be entered of record. Compliance with this rule necessarily requires the court to arrive at its own conclusions on the facts of the case, as well as upon the law.

In the *Ben Avon* case the Supreme Court of Pennsylvania had held that on a question of confiscation, the Commission's determination of facts, if supported by substantial evidence, was not reviewable by the courts; and accordingly without considering conflicting evidence, sustained an order claimed to be confiscatory. This Court reversed the judgment of the Supreme Court of Pennsylvania for the sole reason that on a question of confiscation the Utility is entitled to a judicial determination upon the court's "independent judgment as to both law and facts." *Ohio Valley Co. v. Ben Avon Borough*, 253 U. S. 287,,289.

There is a broad distinction between (1) legislative questions within the flexible limit of judgment which belongs to the power to fix rates which are committed to such agencies as public service commissions, and (2) the constitutional question of confiscation, a judicial question which cannot be committed to any administrative agency to the exclusion of judicial review. Professor Dickinson, in his book on "Administrative Justice and the Supremacy of Law", which is cited by the Commission's brief (p. 45), as supporting its position, fails to make this distinction. He cites and quotes previous opinions of this Court without distinguishing statements

[1]The presumption goes only to the burden of proof and has no evidentiary or probative force: *Lincoln v. French*, 105 U. S. 614, 617; *Mobile, etc., R. R. Co. v. Turnipseed*, 219 U. S. 35; *Western and Atlantic R. R. v. Henderson*, 279 U. S. 639.

on constitutional questions from statements on other questions,—a particularly serious error, when citing cases as involving constitutional questions, he quotes statements *not* on the constitutional question, but on *other* questions.

The Commission cites in support of its position a number of cases decided since the *Ben Avon* case. We submit that the cases cited do not in any way qualify the rule, and the most recent cases in this Court reaffirm and apply the doctrine of the *Ben Avon* case. In *United Railway & Electric Co. v. West*, 280 U. S. 234, this Court weighed the evidence *pro* and *con* as to what was a fair rate of return to the utility and, concluding that a higher rate of return than was allowed by the Public Service Commission of Maryland was necessary to escape confiscation, ordered a reversal. At page 251 this Court said:

> "What will constitute a fair return in a given case is not capable of exact mathematical demonstration. It is a matter more or less of approximation about which conclusions may differ. The court in the discharge of its constitutional duty on the issue of confiscation must determine the amount to the best of its ability in the exercise of a fair, enlightened and 'independent judgment as to both law and facts.'"

In *Crowell v. Benson*, 285 U. S. 22, at page 60, this Court said:

> "In cases brought to enforce constitutional rights, the judicial power of the United States necessarily extends to the independent determination of all questions, both of fact and law, necessary to the performance of that supreme function. The case of confiscation is illustrative, the ultimate conclusion almost invariably depending upon the decisions of questions of fact. This Court has held the owner to be entitled to 'a fair opportunity for submitting that issue to a judicial tribunal for determination upon its own independent judgment as to both law and facts'. *Ohio Valley Water Co. vs. Ben Avon*

Borough, supra. See, also, *Prentis et al. vs. New York Telephone Co.*, 262 U. S. 43, 50, *Tagg Bros. & Moorhead vs. U. S.*, supra, *Phillips vs. Commissioner*, 283 U. S. 589, 600."

Finally, in *State Corporation Comm. v. Wichita Gas Co.*, 290 U. S. 561, in speaking of the right of certain utility companies to obtain in a Federal Court relief from an order of a commission on the ground that it was repugnant to the Federal Constitution, this Court again said (page 569):

> "And upon the issue of confiscation *vel non* they are entitled to the independent judgment of the courts as to both law and facts. *Ohio Valley Water Co. vs. Ben Avon Borough*, 253 U. S. 287, 289. *Bluefield Co. vs. Pub. Serv. Comm'n*, 262 U. S. 679, 689, *United Railways vs. West*, 280 U. S. 234, 251."

The argument on this topic in the Commission's brief also confuses the question of the effect to be given to the findings of a legislative commission by the trial court in a suit based on alleged confiscation, with the effect to be given to the findings of the lower court in similar cases by this Court as an appellate court of review. Thus, the quotation from the *Clark's Ferry Bridge Case*, 291 U. S. 227, on p. 44 of Commission's brief, expressly refers to the "findings of the state court", as covering a "debatable field of fact", which this Court is not required to enter; and the quotation from *Georgia Railway & Power Co. vs. Comm.*, at foot of p. 43 of the brief, says "this question is one of fact, and we are not convinced that it was wrongly decided below", referring of course to the decision and findings of the trial court and not to the findings of the Commission. The fact that in most of the cases cited in this connection in Commission's brief, the case was brought to this Court by the Utility, indicates that this Court had before it the findings of the Commission which had been reinforced by the findings of the court of first instance.

IV.

VALUATION.

The Court made three findings which pertain to the fair value of the used and useful property of the Company, as follows:

Findings of Fact.

(I, 584; 7 F. Supp. 216).

1. The fair value of all the plaintiff's property, including working capital, cash capital, materials and supplies, considered as a going concern, as of December 31, 1933, is $39,541,921.27, of which 85% thereof, to wit, $33,610,632, is used and useful in the public service in its intra-state operations;

2. A fair allowance to the plaintiff company for working capital separately considered is $1,000,000 for its whole operation and $850,000 for its intra-state activities;

3. Going value has not been separately estimated but is included in the total $39,541,921.27.

At the foot of the findings of fact the Court says:

"We refer to the opinion herewith filed for more detailed statement of facts and figures on which these ultimate findings are based."[9]

In its opinion the Court discusses the question of value, and the several disputed issues in that connection, *in extenso* (I, 534-573; 7 F. Supp. 218-234).

---

[9] By reason of the stipulation (I, 96) the legal results are the same whether the property and revenue be considered as a whole or the intra-state portion of the business be considered separately (I, 533; 7 F. Supp. 218). The Commission in their brief (p. 3) and in their statement of points relied upon (II, 1092) have used the figures for the total property and expenses. For convenience, we have in this brief also used data relating to the property and expenses of the Company as a whole.

The District Court's valuation of $39,541,921 includes $1,000,000 for the item of working capital, as the above findings show. When working capital is subtracted from the total the difference of $38,541,921 equals the actual cost of the property of $50,025,278, less the entire depreciation reserve of $11,483,357, both being the amounts as shown by the books of the Company. It is conceded that the books are correct (I, 538).

Exclusive of working capital, the Commission's valuation as of December 31, 1932, was $32,472,831 (I, 56). During the year 1933 the increase in the depreciation reserve exceeded the net book additions to property by $1,220,045 (I, 599). Deducting the latter from the former we have $31,252,786 as the Commission's value brought up to December 31, 1933, but at December, 1932, cost levels.

The difference between the Court's valuation and the Commission's valuation (both exclusive of working capital) or about $7,300,000, is the amount in dispute between the parties on this appeal.

Both the Court's and the Commission's valuation above stated purport to include the element of going value.

The Company presented as evidence of the value of its property (1) the actual cost thereof as shown by the books, and (2) the estimated cost of reproduction new, together with estimates of the amount of depreciation existing in the property, as determined by experienced telephone appraisal engineers. This evidence is discussed hereinafter.

Broadly speaking, the Commission contends upon this appeal that the District Court committed error in two respects, in that:

1. The Court misconstrued the applicable law and the Court's own proper judicial function.

2. Upon the entire record the District Court was bound to approve and accept the Commission's valuation.

Regarding the first of these contentions we need only to refer to what we have already said herein, *supra*, p. 24. The opinion of the Court conclusively refutes the Commission's argument with respect to the law.

We therefore address ourselves immediately to the Commission's second contention as broadly stated above. Our argument in answer to this contention may be summarized in the statement of the three following propositions:

First: The Commission's valuation is an arbitrary amount arrived at by a formula which bears no relation to any logical or sound criteria or method of valuing the property of a public utility. It follows as a corollary to this statement that the Commission's determination of value is thereby shorn of any presumption of validity which the law would otherwise attach to it.

Second: The evidence presented to the District Court by the Commission in support of its valuation has the same infirmity that inheres in the valuation itself.

Third: The evidence in the record clearly and convincingly sustains the District Court's findings of value.

First

The Commission's valuation is an arbitrary amount arrived at by a formula which bears no relation to any logical or sound criteria or method of valuing the property of a public utility. It follows as a corollary to this statement that the Commission's determination of value is thereby shorn of any presumption of validity which the law would otherwise attach to it.

In the Commission's opinion which accompanied the rate order the Commission states the problem as follows (I, 33):

"The problem before the Commission has been to measure the decrease from cost of the Company's property to its present value as of December 31, 1932."

The Commission's formula for solving this problem is stated by it as follows (I, 34):

> "We believe that fair value of a public utility property such as this, for rate making purposes, should, and does, trend directly with the average purchasing power of the dollar and that a trend or series of index numbers to indicate fair value with a high degree of accuracy can be developed by combining the several trends offered by Mr. Smith in such manner as to give reasonable consideration to the influence that each reflects upon the average purchasing power of the dollar from year to year."

The Mr. Smith here referred to is the chief auditor of the Commission. Mr. Smith presented a series of computations, which he denominated "suggested values", which the Commission combined in a manner to be explained later herein in order to obtain its valuation. He was the only witness who testified on behalf of the Commission on the subject of valuation.

In its brief herein the Commission defines, or perhaps we should say characterizes, its method in the following words (Commission's Brief, p. 49-50):

> "Value signifies, in rate regulation, the investment in *dollars* on which a utility is entitled to earn, which must be representative of the sum previously and prudently dedicated to the enterprise in terms of present economic conditions. The dollars when so invested were free units of exchange value, having an earning significance then and now only because they are such units of exchange. When invested

originally, they represented on the one hand so many poles and miles of wire and other units of telephone equipment; on the other hand the same dollar units then represented certain quantities of government bonds, wheat fields, apartment houses, automobiles, fur coats, gold bullion, beefsteaks, services of all kinds, etc., etc. By definition, the dollars invested by the A. T. & T. in the Maryland Telephone Company, had *no* value unless they *were* interchangeable for other requirements and desires of the stockholders of the A. T. & T., and the corresponding requirements and desires of *all* persons who use the dollar as a measure of value. Thus a regulating body in finding fair value must find a number of universal units of purchasing power and earning power; that is, exchangeable dollars invested, in terms of present exchangeable dollars."

The following further excerpts from the Commission's brief are immediately relevant in this connection:

"This fundamental conception is qualified by a policy of regulation that utility valuations shall not swing to speculative heights on the one hand, nor to distress prices on the other. Valuations should therefore respond only to relatively stable levels, such as the low level the United States has endured since 1929." (Commission's Brief, p. 54).

"More important, however, the Commission was convinced, independently of the precedent that the trending of value by the use of accepted index numbers, under the conditions, was the most reliable guide to present value." (Commission's Brief, p. 54-55).

"More significant than these practical considerations, however, it is earnestly submitted that this carefully weighted index valuation resolves the stubborn theoretical *impasse* between prudent invest-

ment and the accepted doctrine of present fair value. The index valuation *recognizes and gives full effect to cost when incurred, under conditions then prevailing.* Using that cost as a basis, it indicates the present earning value of that cost, that is, present fair value." (Commission's Brief, p. 58).

The Commission's witness (Mr. Smith, the Chief Auditor) explained the theory as follows: (I, 397)

> "The economic theory of index numbers is something like this. If you invest $20,000,000 in property in 1923, that $20,000,000, in the normal course of expenditure, would be exchanged for a certain number of commodities. In 1932 you are entitled to the same commodities, and this method would give you in 1932 the same commodities which you could have had in 1923 for the $20,000,000."

The concrete application of the Commission's method is shown by a table in its Opinion (I, 55-56) which, for convenient reference, we reprint opposite page 35 hereof.

Tabulation reprinted from the Commission's opinion (1, 55-56, 76). Showing the concrete application of the Commission's method.

TABULATION FROM COMMISSION'S OPINION.

(I, 55-56)

APPLICATION OF COMMISSION'S FAIR VALUE TREND

		Translator	Value Dec. 31, 1932
Value found by Court, as of Dec. 31, 1923	$36,122,912		
Less Working Capital	975,000		
Amount to be trended from Dec. 31, 1923	$35,147,912	67.4	$23,689,693
Net Additions, 1924	3,199,648	68.2	2,182,160
1925	3,493,429	68.4	2,389,505
1926	4,098,230	70.0	2,868,761
1927	2,837,050	72.6	2,059,698
1928	1,854,046	71.8	1,331,205
1929	2,205,132	72.7	1,603,131
1930	2,733,968	77.6	2,121,559
1931	1,459,483	86.4	1,260,993
1932	421,708	100.0	421,708
Totals	$57,450,606		$39,928,413
Depreciation Reserve			
Court's Value—Dec. 31, 1923	$ 6,614,963	67.4	$ 4,458,485
Net Additions, 1924	(3,556)	68.2	(2,425)
1925	200,429	68.4	137,093
1926	547,335	70.0	383,135
1927	804,711	72.6	584,220
1928	658,770	71.8	472,997
1929	823,816	72.7	598,914
1930	186,866	77.6	144,992
1931	229,100	86.4	197,942
1932	342,733	100.0	342,733
Totals	$10,405,147		$ 7,318,086
Depreciated Value of Property, as of December 31, 1932			$32,610,327
Add Working Capital			737,000
			$33,347,327
Deduct Pleasant Street Property			137,496
( ) Indicates Subtraction.			$33,209,831
Rate Base			$33,210,000

In ascertaining the amount of rate reduction to be ordered the Commission, from the above rate base of $33,210,000, determined an "average value" for 1933, as shown in the tabulation (I, 76) an extract from which is shown below:

Value of Property—December 31, 1932, less Working Capital	$32,610,327
Deduct average increase in Depreciation Reserve less average increase in Fixed Capital	650,000
	$31,960,327
Add allowance for Working Capital	660,863
Average value of Rate Base for 1933	$32,621,190

As shown by the table, the Commission found the undepreciated value of the property to be $39,928,413., from which it deducted the trended depreciation reserve of $7,318,086., deriving as the depreciated value of the property, as of December 31, 1932, the sum of $32,610,327.

The Commission starts with the undepreciated value as of December 31, 1923 as found by the District Court in the former suit (*C. & P. Tel. Co. v. Whitman*, 3 Fed. (2d) 938). Subtracting working capital from that amount, the Commission's computations begin with the sum of $35,147,912. to which it then applies the factor of 67.4%, which gives the sum of $23,689,693 which the Commission carries into its summation.[3]

The Commission then applies the same method of treatment to the book cost of the net additions for each subsequent year. These net additions are the actual cost of new plant added each year less the actual cost of property retired from service and written out of the fixed capital accounts in the same year. The Commission finds, for example, that the net additions to property for which the Company invested $3,199,648. in 1924 have a value of $2,182,160. at the end of 1932. In like manner property added to the plant in 1930, at a cost to the Company of $2,733,968. has a value two years later of 77.6% of such actual cost.

As a matter of fact it is plain that the Commission has not dealt with the property at all. It started with a dollar measure applicable to the property in use in 1923.

---

[3] This sum of $23,689,693 is *undepreciated*. The factor (translator) of 67.4%, it is to be noted, has nothing to do with depreciation, which the Commission deducts further down in the table. There were, of course, substantial retirements from the 1923 property, the amounts of which were currently written off during the ten-year period, *but new property* (included in the gross additions to plant) *was substituted in place of the property retired*. It will be noted that only *net* additions are added by the Commission for the subsequent years. There is thus neither disappearance of units of property nor depreciation reflected in the percentage translators.

It then trended that dollar measure. And likewise, with respect to annual additions to the plant, it merely trended the dollar figure which reflected the difference between the cost of property added and the cost of property retired each year. In a confiscation case the law requires the Court to deal with the value of the property used and useful in rendering service. Figures showing annual net additions, as reflected on the books, are useful in measuring growth of total investment, etc., but they have no use whatever as a means of even identifying, to say nothing of valuing, the particular plant which is in use at a particular time. The kinds and quantities of such items are shown by the Company's records, and the accuracy of such records was recognized by the Commission at the trial.

The depreciation reserve is then treated in identically the same manner as the plant and is reduced by the application of the identical percentage factors applied to the plant; the reserve thus computed is taken to represent the depreciation existing in the plant and is deducted in arriving at the value.

The District Court gave careful consideration to all of this testimony. The methods by which the Commission obtained the percentages which it applied in each year, their lack of reality, and their arbitrary character, cannot be better shown than by quoting what the District Court has to say concerning them in its Opinion (I, 558-560; 7 F. Supp. 228):

> "What the Commission did was this. It approached the rate hearing under the conviction that the Telephone Company's rates must be reduced in view of the general changed economic level of prices. In its investigation it made no new physical inventory or appraisal of the Company's property and produced no testimony either in the hearing before the Commission or here as to valuation except to depre-

ciate book costs (as enhanced by the court's finding of value in the 1925 case) by applying to the valuation as found by the court in 1925 and the net additions to the plant in subsequent years, a so-called 'index translator' of values to reduce values as established in 1925, with subsequent annual additions, to values as of December 31, 1932, in accordance with an index of prices determined by the Commission to represent the 'fair value trend.' In other words, the Commission valued the Company's property on the basis of the ratio that values in 1925 and subsequent years respectively bore to values in 1932 as determined by this so-called fair value trend. This method of valuation was adopted by the Commission in order to save the time and expense that would be involved in a physical appraisal. Nevertheless the Company did submit in the hearing before the Commission full data in support of its valuation based on reproduction cost new less depreciation. The Commission, however, disregarded this in its conclusion. The Commission's method in obtaining the so-called index translator to establish the relationship between values in 1925 and succeeding years with those of 1932 is fully explained in its opinion and is graphically illustrated by a chart appearing opposite printed page 29. The Commission developed an index for values which it called a 'fair value' trend. This it evolved as a composite of several separate price trend curves which are referred to in the opinion and included in tables appearing at pages 24 to 28 inclusive. The Commission described its method in a note on page 26 as follows:

> 'These "Fair Value" Translators are based upon December 31, 1932, as 100, and are intended to be, respectively, the percentages which, when applied to the value of the dollar at December 31, 1923, and to the average value for each of the years 1924 to 1931, inclusive, will produce value as of December 31, 1932.'

"The Commission developed its own curve or trend by taking a 'weighted average' of 16 separate in-

dices for prices of certain commodities and construction costs. Taking the whole value of all the price trends considered as indicated by the number 31, it assigned (on what exact basis does not clearly appear) a value to each of the several price trends. Thus to the United States Department of Labor 'all commodities' trend it assigned a value of 4; to the National Association of Purchasing Agents (commodity) trend, a value of 2, etc. As a result it deduced a price curve or ratio of price which was not greatly different from the so-called 'all commodities' average put out by the United States Department of Labor. The latter is understood to represent the average price trend from 1923 to 1932 inclusive, of 784 commodities as raw materials. These 784 items are themselves sub-divided into a number of different sub-classes. The items in the sub-classes vary greatly as to their respective price trends. And the values which would be produced by the several price trends considered by the Commission also vary widely. By comparison we note that the value produced by the 'fair value trend' of the Commission as of December 31, 1932, for the Company's property (after deducting depreciation) was $32,610,327., but as of December 31, 1933, the application of the all commodities price trend (which for December 31, 1932, was at a lower level than the Commission's fair value trend) produced $34,332,453.56; while the price trend of the Engineering News Record (given a weighted value of 2 by the Commission) produced $41,036,789.48."

Perhaps we should refer briefly to two indexes included among the sixteen indexes entering into the Commission's "translator", and upon which the Commission seems to lay considerable stress, namely, the Interstate Commerce Commission Index for Telegraph and Telephone lines of railroads and the so-called Western Electric Index.

The I. C. C. special index was put forward by the Commission as being evidence as to telephone construction

costs. It is used in Exhibit D-5, p. 63 (II, 867), and also in conjunction with certain other I. C. C. Railroad Construction Indexes on Exhibit D-5, p. 69 (II, 870).

Before the District Court it was explained (I, 421, 525), that the I. C. C., after determining the 1914 reproduction cost of the property units of railroads existing at the date of the inquiry and being valued, used cost multipliers for the purpose of converting the 1914 reproduction cost into reproduction cost as of the date of the inquiry. These cost multipliers were prepared for use and are used by the I. C. C. in this definite, specific manner, and are developed for each class of property owned by railroads (Exhibit A-55; II, 808B). Such multipliers are in no sense an index series (I, 253) and have no direct relation year by year. The multiplier for any year has only one function, namely, that of translating the 1914 reproduction costs of a certain class of property into reproduction cost current as of the year for which the multiplier is developed.

Mr. Smith admitted (I, 422), that he had not used these multipliers in the manner in which the Interstate Commerce Commission uses them and he has actually used them for a general purpose for which the I. C. C. specificaly states they cannot be used,[4] and in ways not within the contemplation of the makers of the index.

If anything further need be said, it may be pointed out that the I. C. C. Index for Telegraph and Telephone lines of Railroads is, in fact, not representative of the property items making up the Telephone Company's property. For example, for Central Office Equipment, the Commission in Exhibit D-5, p. 69 (II, 870), have used an

---

[4] The specific sheets on which these cost multipliers are listed appear in Exhibit A-55, p. 3 (II, 810A), and contain the following notation:

"The indices represent territorial index factors and are not applicable for use in the determination of unit reproduction costs upon individual roads."

index called "Telephone Equipment Index", which is an index of a certain type of telephone instrument, plus a small switching device. The sample from which this index was prepared is priced at a cost of $45.70 in 1932, and is labeled "a typical telephone instrument" (see Exhibit A-55, p. 7; II, 813). With this $45 sample of a telephone instrument, Mr. Smith undertakes to value the Company's central office telephone equipment costing nearly $12,000,000., and comprising entirely different types of highly engineered and complex assemblies of many different units.

This so-called index, or list of cost multipliers, has been dissociated by the Commission from the particular data for which it was prepared, and applied to property to which it has no relation, in a manner for which it was not prepared. The results obtained can neither measure nor trend costs or changes in value.

The second special purpose index, is the so-called "Western Electric Index," to which the Commission's brief (p. 56), refers as "Western Electric index number which was filed by the Company before the Commission."

If this statement is intended to mean that the Telephone Company offered in evidence an index of Western Electric prices for the purpose of valuing its property, the statement is in error. The Telephone Company, both before the Commission and before the Court, presented Exhibit A-20, (II, 665), showing the estimated effect of changes in prices of new telephone apparatus and equipment *only* during the years 1921 to 1933, the price levels in effect in any one year being expressed as a percentage of the 1920 prices (I, 146). On Exhibit D-5, p. 67 (II, 868), this so-called index of changes in prices of new apparatus and equipment (about 25% of the Company's total property—I, 423), after being adjusted to eliminate

the price increases since 1929, was applied by the Commission to the *total* property of the Company.

Exhibits A-50, A-51 and A-52 (II, 804, 805, 806), show in chart form the Western Electric prices for new apparatus and equipment, and also the Western Electric total prices for materials. These charts show that the Commission in its computations is relating the costs of the total property of the Company to the 1929 cost level, the lowest possible level, of apparatus and equipment, and entirely ignoring the costs of the different types of materials and labor making up the remaining 75% of the Company's property.

The so-called "Western Electric Index" is not suitable for the purpose for which it has been used, does not apply to the great bulk of the property, and as used by the Commission takes the lowest possible point to which to relate the costs of the Company's property.

Before the District Court it was demonstrated that the Commission's methods of valuation were defective in principle and in the application thereof, to such an extent that no reliable results could be obtained therefrom. On the evidence before it, the District Court reached its conclusion to reject the Commission's valuation, saying (I, 560; 7 F. Supp. 229):

> "It is apparent • • • there is the essential fallacy of *assuming* that an *average trend of all prices*, whether absolute or weighted, is a true index for the trend of construction costs of the special kind of property with which we are here dealing, whether the valuation of telephone property is based on historical cost or reproduction new, it is, we think, obvious that the price change over a period of years can only fairly be reflected by developing a price ratio or trend for the costs entering into this particular kind of property. It is quite erroneous to assume that *changes in the price level* of *certain*

> commodities or the *average* of any number of commodities is similar to that of a *particular* commodity or property. This fact is amply demonstrated in the tables to be found in the Commission's opinion and in many of the exhibits filed by its counsel in this case. The fallacy of the Commission's method is also thoroughly and convincingly demonstrated in the oral testimony of plaintiff's witnesses: Barker, a valuation expert for the Vermont Commission, and a Dr. King, an experienced economist and statistician."

The Commission's method may accurately be denominated "the commodity dollar valuation theory". An accountant armed with a calculating machine (a slide rule would serve the purpose), supplied with the Commission's index (derived from 16 others), and having available the Company's books of account or accounting reports, can readily determine the value of the Company's property without knowing anything about the property or the business and without the aid or advice of any person who does know. The Chief Auditor was the Commission's only witness on valuation. The two general engineers who did testify for the Commission did not touch the subject of valuation. Valuation is a matter of judgment and is not a matter of formula. The Commission adopted a formula from which it *computed* what it calls value, and based the telephone rates in suit upon the result. Its action was arbitrary and deprived the Company of its property without due process of law. (*Northern Pac. R. Co. v. Dept. of Public Works*, 268 U. S. 39, 42-44). Upon the trial of the suit it persisted in the same error and relied upon the same evidence from the same witness who testified in the Commission hearings. And now the Commission is before this Court stoutly maintaining the same position and insisting that it is the District Court that has been arbitrary in rejecting its methods.

Practical Result of Commission's Methods.

The severity and hardship to the Company of the Commission's valuation may be shown by the following comparisons. On December 31, 1923, the book cost of the Company's property was $28,000,000, the depreciation reserve stood at $6,400,000, and the so-called "net cost" was $21,600,000. Between 1923 and December 31, 1933, the gross additions to plant amounted to $44,600,000 and the retirements to $22,600,000. The book figures for 1933, for the items above stated for 1923, are $50,000,000, $11,500,000 and $38,500,000, respectively. The subjoined table shows these figures.

	Dec. 31, 1923	Dec. 31, 1933
Book Cost	$28,000,000	$50,000,000
Depree. Reserve	6,400,000	11,500,000
Net Cost	21,600,000	38,500,000

In the ten year period the book cost *less* the depreciation reserve (or net cost) increased by $17,000,000; that is, the Company invested that additional amount (net) in expanding the property in ten years. The growth in the plant in that period to meet the increased demand for telephone service is indicated by the increase in telephone stations from 159,000 in 1923 to 199,000 at close of 1933.

The District Court in this case valued the property in service on December 31, 1933, at $39,541,000, including going value. In the 1925 suit the District Court found a value as of December 31, 1923,[5] of $29,500,000. That is to say, the value now found by the District Court is only $10,000,000 more than the value of the smaller property of 1923. The result of these two decisions ten years apart is that by making a net investment of $17,000,-

[5] C. & P. Tel. Co. v. Whitman, 3 F. (2d) 938.

000 the Company has acquired a value increment of $10,000,000.

The Commission is not satisfied with this. It says the Court's action is arbitrary. It insists that the value for 1933 is not more than $32,000,000; that the sum of $17,000,000 invested by the Company since 1923 to meet the needs of the people of Maryland for telephone service has added only $3,000,000 to the then value of the investment upon which the Company is entitled to earn a return.

Second

The evidence presented to the District Court by the Commission in support of its valuation has the same infirmity that inheres in the valuation itself.

Before the District Court, the Commission's Chief Auditor (Mr. Smith) presented the identical statistical computations that are referred to in the Commission's opinion. The Commission's Exhibit D-5 contains the tabulations (similar to that which we have reprinted *supra* from the Commission's opinion) for the application of the several indexes, as a result of which Mr. Smith computed what he called "suggested values". In addition the results of the application of fourteen of the indexes are shown in summary form in Exhibit D-5, p. 71, (II, 871). The amounts shown for "Value—December 31, 1932" are identical with the amounts shown in the Commission's opinion (I, 36).

The foregoing argument upon the first point therefore applies with the same force to the evidence of the Commission's witness before the District Court and sustains the proposition above stated.

The varying results obtained by the Commission's method are in themselves proof of the fallacy of this method.

Referring to this the District Court (1 [illegible]662; 7 F. Supp. 230), points out that one of the objections to the method used by the Commission is the highly variable results obtained by the application of the method in a period of changing prices. The Commission's opinion refers to the fact (4, 77), that between the end of 1932 and September, 1933, a change in prices of approximately 13.1% had already occurred, which the Commission deemed it necessary to take into consideration." (It was because of this increase in general prices that the Commission found it necessary to allow the "margin of $396,000," or "cushion" in the return to the Company which the Commission's brief repeatedly stresses, (pp. 10, 61, 167), and which we have already shown was insufficient for that purpose)."

Before the District Court, the Commission introduced Exhibit D 5, p. 71 (II, 871), which discloses that *during the year* 1933 *the increase in* "suggested value," as indicated by the indexes used, *varied from approximately* 28% *to* 3%, and that, as indicated by the All Commodities Index, the increase in value of the 1932 property was approximately $4,000,000, during the year 1933. (This exhibit also shows the different amounts which were obtained as of December, 1932, by the application of the several indexes which the Commission used and to which the District Court called attention (I, 559-560).

Exhibit D-5, p. 4 (II, 841), shows that, as of December, 1933,[6] (with 1926 as 100), the All Commodities Index stood at 70.8, which, as is seen from Exhibit D-5, p. 71 (II, 871), is an increase of 13.1% over 1932. This Court has heretofore taken judicial notice of this index and may properly take judicial notice that as of December, 1934, the index stood at 76.9, and as of February, 1935,

[6] If the indexes on Exhibit D-5 (II, 871), are weighted by the same method which the Commission used, the increase in value would be 14.72% for identically the same property, though the Wholesale Commodity Price Index shows 13.1%.

at 79.5, (that is, 122.84% and 127%, respectively, of the level of December, 1932, the date to which values were trended by the Commission). These changes in the index indicate that *according to the Commission's method and bringing the Commission's value at 1932 levels up to December 31, 1933* (our Brief p. 30), the property would have been valued at $31,252,786; would have been worth at December 1933 levels $35,346,901; at December 1934 levels, $38,390,922; and at February 1935 levels $39,691,038. Yet this Commission is protesting against a value as found by the District Court as of December 31, 1933 of $38,541,921.

Commission's Methods Would Now Give Value Greater Than Court's.

Since the difference between the value (excluding working capital) found by the Court and that found by the Commission brought up to December 31, 1933, is slightly less than $7,300,000 (our brief p. 30), the above figures show that if the Commission had not stopped its composite index figures at December, 1932 (approximately the lowest point attained), but had allowed for the increase of 13.1% in all commodity values from that point to December 31, 1933, in determining value as of said latter date (when its reduction order was to become effective); then $4,094,115 of this $7,300,000 difference between the Court's and Commission's values would have been eliminated. If the Commission's own composite curve were similarly continued to December 31, 1933 (Exhibit D-5, p. 71, weighted: 11; 871), then approximately $4,600,000 of the difference would have been eliminated.

If the December 1934 All Commodities Indices were similarly used (the other indices combined to form the Commission's composite index not being available to a

later date than as proved in the record, nor probably within the judicial notice of this Court), the increase in value since December, 1932, amounting to 22.84% (Appendix, "Graph"), would give over $7,100,000, or within $200,000 of the value found by the Court. And if the latest All Commodities Index figures now available (February, 1935, Appendix, "Graph") be $8,400,000, making it actually exceed the value found by the Court by over $1,100,000.

Third.

The evidence in the record clearly and convincingly sustains the District Court's findings of value.

The District Court determined the value of the Company's total property as of December 31, 1933 to be the total amount of $39,541,921 inclusive of going value, which was not separately estimated, and also inclusive of the Company's requirements for working capital separately found in the sum of $1,000,000.

The Company offered two evidences of value before the Court:

(a) the book cost or historical cost of the Company's property;

(b) the reproduction cost new and reproduction cost new less depreciation of the Company's property.

(a) The Company's book costs. Since 1913 the actual costs of the Company's property have been entered on the books of the Company under the accounting rules prescribed by law. It is conceded by the Commission that the Company's books record the actual cost of the property, and the District Court found that the accuracy, fairness and completeness of the cost data as recorded in the Company's books was not challenged (I, 538; 7 F. Supp. 220).

As of December 31, 1933 the accumulated book cost of the property amounted to $50,025,278 (Exhibit A-2; I, 599).

(b) Cost of Reproduction. The Company's estimate of cost of reproduction new of the physical property as of December 31, 1933 was $49,031,267. The reproduction cost, less depreciation of the physical property as determined by the engineer's inspection method, was $42,307,846 (Exhibit A-32; II, 753).

(We discuss *infra* pp. 60-82 the Commission's criticisms of these estimates of cost of reproduction.)

The District Court in determining its finding of fair value as of December 31, 1933 deducted the entire depreciation reserve of $11,483,357 from the total accumulated book cost of $50,025,278, arriving at the amount of $38,541,921 above stated.

The District Court did not, as argued in the Commission's brief, take "prudent investment" as a measure of the value of the Company's property. What the Court did was to consider the evidence of reproduction cost together with the accumulated book costs and all other relevant evidence in the case. The Court found that the reproduction cost new and the actual cost corresponded closely and supported each other in so far as the undepreciated value was concerned. The Court, having regard to all the facts and relevant circumstances of the case, including the Commission's evidence, found that the fair value of the Company's property was equal to the amount of the accumulated book costs, less the entire amount in the depreciation reserve account.[7]

[7] It is not intended here to argue the question as to whether or not in finding fair value the entire amount of the balance in the reserve should be deducted but we point out what the Court did in order to refute the suggestion that the Court adopted "prudent investment" as its basis for finding value.

The Court after carefully considering the Company's estimates of reproduction cost found in effect that the estimate of reproduction cost new (even after making a deduction of $1,500,000 for which the Commission contended—I, 551, 567; 7 F. Supp. 225, 232), offered substantial corroboration of the book cost of the property which the Court used for the undepreciated value.

(c) Going Value.

The District Court (I, 552; 7 F. Supp. 225-226) held that there was a substantial going value in the Company's property. It did not assign a specific amount to going value, but said that it had taken account of the evidence and that in taking book cost less depreciation as the first measure of value of the Company's property, it had included and given fair recognition to the element of going value. The Commission does not take any exception to that action of the Court. It does not contend that there is not an element of going value in the Company's property or that the Court has included too much on account of going value.

On the contrary the Commission is here merely contending that the estimate of going value submitted by the witness Sloan is so "conjectural and uncertain" and "so grossly in excess of the actual cost of establishing such value in the Company's present plant", that the evidence of value offered by the Company is deprived of evidentiary weight and probative force (Commission's Brief, p. 145).

If the Trial Court committed any error with respect to that subject, it was against the Company.

The Court included no specific sum for going value, pointing out, however, that it had not failed to consider it as an important element in the valuation (I, 552; 7 F. Supp. 226). This action of the Court eliminates, as the Court points out (I, 552), the amount of $705,000

which the Commission itself had fixed as going value in *Case 690* (the 1916 telephone case), as being an outlay by the stockholders which had not been repaid out of current earnings, and which therefore the owners of the property were entitled to have added to the cost of the physical property (II, 1004). This amount of $705,000 recognized by the Commission for many years as not having been included in the Company's book cost, is clearly part of the property devoted by the Company to the public service, upon which it is entitled to earn a fair return. The valuation adopted by the District Court in this case eliminated this item.

(d) Accrued Depreciation.

In arriving at fair value of the Company's property the District Court deducted from the book or historical cost of the property the balance in the Company's reserve for accrued depreciation.

In its opinion of November 28, 1933 the Commission (I, 55) held that the Company's "depreciation reserve, when all the circumstances surrounding it are taken into consideration, is a much better measure of depreciation, visible and invisible, actually existing in the property, than the Company's estimate."

The amount deducted by the District Court was $11,483,357. The Commission deducted $7,318,086, the difference being due to the fact that the Commission applied its value trends "to the reserve accruals".

There was no difference between the District Court and the Commission as to how the existing depreciation should be measured. The Commission's exhibits showed the amount in the reserve, and the derivation therefrom of the "trended" smaller figure which the Commission deducted from its trended base for computing value.

In principle there was no distinction between what the District Court did and what the Commission did, which its brief now says was proper.

The Company's Property Used and Useful in Its Public Undertaking.

The Court included in the finding of value one item of property which was disallowed by the Commission as not being property used and useful, *viz*: the site bought for an exchange by the Company some years ago, and referred to as the property at St. Paul and Pleasant Streets (I, 571; 7 Fed. Supp. 234).

The amount of this item is not large (less than $200,000), and it cannot therefore play an important part in determining the question of confiscation. The evidence (I, 116), which is carefully considered by the District Court in its opinion (I; 571), showed that in locating a new exchange, the particular site, with respect to the district to be served therefrom, is of essential importance from the standpoint of economical service; and that if such a site is not acquired when the opportunity offers, it may be necessary later on to acquire it at much greater expense owing to the construction of expensive improvements which would have to be paid for and then torn down. The Court accordingly concluded, that the outlay for this piece of property was made in the reasonable exercise of business judgment on the part of the Company, within the scope which should be allowed it for the prudent management of its own affairs.

See

Denver Union Stockyards Co. v. U. S., 57 F. (2d) 735.

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615.

The Commission also contends (in contradiction of its own findings, I, 72), that the fact that the Company's stations or subscribers had shrunk due to the depression (Commission's Brief, p. 111) is sufficient

evidence that there was "a large amount of property not used and useful in rendering service", included in the plant of the Company; and that the Company's plant had been built up to the "boom requirements of 1929" and should now be correspondingly cut (*id* p. 110).

For the purposes of comparison, the Commission's brief cites as authority for its contention such cases as *San Diego Land &c. Co. v. Jasper* (189 U. S. 439), which dealt with a plant initially constructed beyond reasonable requirements; the *Los Angeles Case*, involving a "stand-by plant"; and the *Columbus Gas Case*, where the Court had under consideration gas leases "bought with income * * * and thus paid for in the last analysis through the contributions of consumers." None of these conditions exist in the present case.

The growth of stations in the Company's business is shown in graphic form by an exhibit filed at the hearing below by the Commission (II, 1090-A), which shows that even at the lowest point reached in 1933, the number of stations was not far below what it was in the alleged "boom time" of 1929; and that at the time of the hearing below a substantial increase in stations had already set in, which was estimated in the evidence (II, 797) as continuing through 1934 with an increase of 5,000 stations during that year.[8]

The Commission's contention goes even further and suggests the elimination of certain wires because only partly used. The same theory was considered in *Denver Union Stock Yards v. U. S.*, (1932) 57 F. (2d) 735, where the District Court said (p. 747):

> "There is no rule of law that denies to the directors of a stockyards company or of a telephone com-

[8] The actual result for 1934 has shown a larger increase than that predicted, according to the annual report of the Company which counsel for the Commission seek to bring to the attention of this Court in the Appendix to their brief.

pany the right to use ordinary business judgment in the conduct of the affairs of the corporation. The rule of law adopted by the Secretary would deny to a telephone company the right to include in its rate base the value of any cable that was laid, unless every wire in the cable was in actual service; it would deny to an electric power company the right to include in the rate base the value of the power plant, unless it was being operated to its maximum capacity. Such a rule does not conform to sound business methods, nor to the rules of law as laid down by the courts."

This Court has recently declared:

> "In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay." *West Ohio Gas Co. v. P. U. C. Ohio*, (Jan. 7, 1935), 55 S. Ct. 316.

There is no evidence that any of the property in question was not reasonably provided and would not be required for the public service. The Commission itself so held (I, 72); and the District Court allowed all of the property items included in the Company's statements of cost and estimates of reproduction value as being used and useful in its public undertaking.

Working Capital.

The Commission contends in its brief (p. 74), that the District Court erred in finding, and including in the rate base, working capital in the amount of $1,000,000.

Much of the argument in the Commission's brief (pp. 74, 79), relates to the question of the Scope of Judicial Review which we have already discussed under Point III of this Brief (pp. 24-28, *supra*). The trial before the District Court was a trial on the constitutional question of confiscation and the District

Court was required, on this issue of confiscation, to exercise its own independent judgment of the law and the facts upon the evidence adduced before it. This legal requirement was recognized by the District Court (See I, 562; 7 Fed. Supp. 234), and its findings of fact are based on the evidence before it.

The Commission offered evidence of the amount of working capital. As the District Court points out (I, 572; 7 Fed. Supp. 234), the Commission, owing to a misunderstanding of the facts relating thereto, had excluded $158,048 for certain materials and supplies known as "Class C stock" (I, 203, 211). The restoration of this item raises the amount of working capital from $660,863, which the Commission had allowed, to $818,911., under the Commission's own method. This must be taken as the amount of working capital which the Commission should have found on their basis.

Prior to the present telephone case, it had theretofore been the practice of the Commission (I, 70) to allow for working capital an amount equal to one-eighth of the annual operating expenses, plus materials and supplies, but in this case the Commission decided to change this practice as to this Company. The reason advanced for this change in practice was that, "it was developed that its bills for exchange service are sent out and collected in advance." This method of billing has been long established and is one which has been within the Commission's knowledge from proceedings in the other telephone cases. In this case the Commission adopted a new standard of measuring the length of time for which working capital is needed, but in doing so arbitrarily eliminated certain items from the operating expenses (which it used as its base) on the ground that the expenses so eliminated would not require working capital (Commission's brief, p. 75). Among the items so eliminated was the amount

of the license payment, admittedly a proper operating expense (See Stipulation, I, 95), which is paid monthly no matter as of what date the amount is computed (I, 208). Likewise interest is paid monthly to obtain the advantage of a discount which reduces the amount of interest (I, 105) and therefore reduces the amount of cash needed. Pension accruals in excess of the actual payments for pensions were also excluded though the uncontradicted testimony is that the Company does make a cash payment and that the accruals in the fund are less because of interest accumulations on the excess which has been excluded by the Commission (I, 209). Taxes are eliminated by the Commission because payments are made in arrears, but no correction or adjustment is made for items which the Company pays in advance (I, 210).

Restoring these arbitrary and unjustified eliminations, and applying the Commission's method to the total operating expenses, the amount of Working Cash Capital (as of 1932, being the same year as used by the Commission) would be approximately $720,000., to which should be added Materials and Supplies (including Class C stock) of $407,000., making a total of $1,127,000.

The method of determining working capital is immaterial so long as a reasonable amount is allowed to meet the necessary requirements of the Company. It would have been possible to do what the District Court did in 1925 (3 Fed. (2d) 938) and compute working capital on the basis of the working assets of the Company, thereby allowing for this item the sum of $1,392,360. (I, 209), when the Company was about two-fifths of its present size. In 1914 (the date of the valuation in Case 690), this Commission allowed the sum of $500,000. when the property of the Company was less than one-fourth of its present size (II, 957).

For the convenience of this Court we have set out a tabulation of the amounts of working capital allowed this Company in previous cases, together with the several computations which were before the District Court in this case.

	Amount	Percentage of Plant Cost	Percentage of Operating Expenses
Case 690 (II, 923, 957) 1914	$500,000.	4.1%	17.8%
C. & P. Tel. Co. v. Whitman, 3 F. (2d) 938 (the 1925 Telephone Case) (I, 209)	1,392,360.	5.0%	17.0%
Commission's allowance (1933) (I, 72)	660,863.	1.3%	6.7%
Commission's allowance adjusted to include Class C stock (I, 572)	818,911.	1.6%	8.3%
Commission's allowance adjusted to a base of total operating expenses and to include Class C stock (See *supra*, p. 55)	1,127,000.	2.3%	11.4%
Amount claimed by Company (Exhibit A-33, II, 756)	1,615,000.	3.2%	16.3%
Amount allowed by District Court (I, 573)	1,000,000.	2.0%	9.9%

Upon this conflicting evidence the District Court exercised its independent judgment on the facts, as it was required to do under the law, and the amount of

$1,000,000 for its total operations (or $850,000 for its intra-state activities) as found by the Court (I, 584; 7 Fed. Supp. 234), was not excessive, but on the contrary was extremely conservative and constitutes a minimum, reasonable allowance for this element of property devoted to the public service.

V.

REPRODUCTION COST NEW.

Point III (II, 1095) of the Commission's Statement of Points to be relied upon and Subdivision IX (pp. 101 to 151) of the Commission's brief herein relate entirely to "The Company's evidence of the cost of reproduction new of its property." The point the Commission states in each of these main headings is that the evidence referred to is deprived of *much* of its evidentiary weight and probative force because it was "based on hypothetical calculations" and was "grossly in excess of the fair and reasonable value, and *a fortiori* the minimum non-confiscatory value" of the Company's property.

The questions the Commission attempts to press upon this Court relate only to the degree to which certain estimates put in evidence by the Company had weight and probative force.

All the evidence in this case was heard by all three of the Judges who constituted the District Court, and all the evidence under discussion was received by that Court without any objection being made thereto by the Commission. The Company's estimates were fully explained by the witnesses: there was extensive cross-examination, and the Commission itself introduced much evidence, both oral testimony and exhibits, in presenting to the Court all the contentions now advanced that the Company's estimates of reproduction cost were excessive. The District Court having heard all the evidence and having con-

sidered all the contentions now advanced by the Commission, made certain adjustments in the Company's estimates and then used the results as a check upon the measurement of value which upon the whole evidence the Court decided to use.

The Commission introduced no estimate of the cost of reproduction, preferring to rest its case upon its theory of "trending" values, discussed elsewhere in this Brief (pp. 31-47).

The estimates of the cost of reproduction of the physical properties which were introduced by the Company are shown in summary form in Exhibits A-31 and A-32 (II, 736, 753), applicable respectively to December 31, 1932 and December 31, 1933, the total amounts being as follows:

Reproduction Cost new of Physical Property as of December 31, 1932 (Exhibit A-31; II, 736)	$48,211,121.
Reproduction Cost new of Physical Property as of December 31, 1933 (Exhibit A-32; II, 753)	$49,031,267.

The estimates were the result of actual engineering reproduction cost studies in which well known and long recognized engineering methods of determining reproduction cost new of utility property were applied to the various individual classes of the Company's property. For more than 60% of the total property they were based on actual quantities and reproduction unit costs of labor and material as of the respective dates. The reproduction cost of the remainder of the property was determined by the use of adequate sample data developed from property of a similar nature, and the sample data so developed were representative of the classes of property from which the samples were taken.

The property of the Company falls naturally into three groups, as follows:

Land and buildings,—7% of total

Telephone apparatus and plant other than land and buildings,—89% of total

General equipment and miscellaneous plant,—4% of total.

Land and Buildings.

In accordance with the stipulation between the parties (I, 95), land was included at an agreed aggregate fair market value.

The reproduction cost as of December 31, 1932 and as of December 31, 1933 of the buildings in Baltimore and the other large buildings of the Company, was determined by Mr. Frainie and Mr. Cummins, competent local builders of long experience (I, 119-132). Their estimates were fully explained to the trial Court but when counsel for the Commission advised the Court that "the parties were not in dispute as to the methods used in obtaining the reconstruction cost new," (I, 123), these witnesses were relieved from testifying as to all the details of their methods and figures.

The aggregate amount of the reproduction cost of the other buildings (about 11% of the total) was stipulated, (I, 95-98) and such reproduction cost was included in the Company's estimates.

Telephone Apparatus and Plant other than Land and Buildings.

The methods applied in ascertaining the reproduction cost new of this telephone plant were fully explained by the Company's witnesses, Mr. Gretz, its General Auditor

(I, 185), Mr. Speer, its Chief Engineer (I, 222), and Mr. Sloan, a consulting engineer (I, 262).

Each class of plant was studied and methods were developed for the purpose of determining the reproduction cost of such class of plant on the basis of a wholesale construction program. The kinds and quantities of plant involved were not in dispute between the parties. (Commission's Brief p. 103).

General Equipment and Miscellaneous Plant.

For these minor classes of property, Mr. Gretz testified as to the studies which he had made and from which he had determined the reproduction cost new of this class of property. Except as the Commission desires to apply its theory of trending to this plant, there was no controversy before the District Court and there is no controversy before this Court as to this class of plant.

The Company's Methods.

It is contended in the Commission's brief (p. 101), that the Company's reproduction cost was based on hypothetical calculations and (p. 114), on arbitrary and erroneous assumptions. These contentions are mere reiteration of the same points set out in the Commission's opinion (I, 23-31), on which the order challenged in this case is based.

The testimony of the Company's witnesses who had taken part in the preparation of the estimates of reproduction cost was corroborated by Mr. Barker, a consulting engineer of wide experience (I, 237), whose qualifications were unchallenged. Mr. Barker was fully acquainted with the various recognized methods of valuation and is required by his business to keep in touch with the developments in the field of valuation of utility properties. He was employed by the Company for the specific

purpose of testing and checking the methods used in preparing the Company's estimates of reproduction cost new of the physical property (I, 239), other than land and buildings and certain minor items of property not specifically appraised.

Before the District Court Mr. Barker refuted *each and every one of the objections* advanced by the Commission and now reiterated in the Commission's brief.

The record discloses in detail the very thorough manner in which he tested the methods followed and the results of applying such methods (I, 250-255). This witness gave it as his opinion that the methods were well adapted to the problem and that the resulting figures presented fairly the reproduction cost of the property included therein (I, 255). Mr. Barker showed such understanding of the problem, and such careful testing and checking of the Company's studies, that counsel for the Commission, in open court, waived further proof of the other tests made by this witness. Thereupon the Court stated that the proof was not necessary (I, 255). Mr. Barker's testimony that the methods followed by the Company were sound and that the estimates resulting therefrom were conservative stands unchallenged and uncontradicted by anything in the record (I, 252, 255).

The District Court did not err in giving evidentiary value to the Company's estimates (Opinion, I, 535, 548-551; 7 F. Supp. 218, 224-225).

Western Electric Prices.

Throughout the period involved in this case the Company has purchased from the Western Electric Company about 90% of the materials it has required. Over 99% of the stock of Western is owned by A. T. & T. Co. which also owns all the stock of the Company. Western,

under contracts (Exhibits A-11 and A-12; II, 645, 653), with A. T. & T. Co. and under the Supply Contract (Exhibit A-21; II, 666), with the Company (the latter being like the contracts in force between Western and each of the operating companies in the Bell System) is in effect the manufacturing and supply department of the Bell System. It manufactures and sells to the operating companies telephone apparatus and equipment and lead-covered cable and it also acts as purchasing agent for those companies in obtaining supplies of all kinds, this term including all articles not made by Western which the operating companies may desire to purchase through Western. The contracts do not require the operating companies to buy anything from Western, but in fact those companies have for many years found it to their advantage to buy from Western (I, 566; 7 F. Supp. 231-232).

The Commission, in its earlier telephone cases, found that the Company's arrangements with Western were valuable to the Company and advantageous to its ratepayers (*id.*). In the Court below the only witness for the Commission on this subject was its chief auditor, who testified that "the public was probably benefited by the Western Electric" relationship and that he "would not want to see the conditions changed" (I, 410-411). The *relationship* between the Company and Western is not an issue before this Court.

Western's *prices* to the Company have been at all times the same as its prices to other companies in the Bell System. Western's prices to non-Bell customers have not been lower than its prices to Bell Companies and generally have been higher than Bell prices (I, 438).

Western's prices were before the Court below in two aspects only:

They were the prices paid by the Company for new materials and are therefore reflected year by year in the book cost of additions to plant.

The prices in effect December 31, 1933, were the prices for materials upon which the Company's estimates of reproduction cost of the plant were based.

In the Court below the Commission's chief auditor testified, and of course Commission's counsel made no point to the contrary, that Western's prices in effect during the years prior to 1930 were reasonable. The witness did criticize a change made in Western's prices on November 1, 1930, but in this connection said that the amount of property acquired at those prices was so small that no question had been made about taking the total cost shown on the Company's books as the proper historical cost of the Company's property (I, 437-438). The Commission itself had dealt with book costs in that same way. No question concerning Western's prices as reflected in book costs is before this Court (I, 567).

The only question before this Court concerning Western's prices therefore relates to the use of such prices in the estimates of the cost of reproduction of the Company's property (I, 567; 7 F. Supp. 232). That question arises in this way.

During the years prior to 1929 Western's business with Bell companies had grown rapidly from a total volume of $188,159,000. in 1923 to $372,384,000. in 1929 (Exhibit A-17; II, 661). During those same years Western's prices for new apparatus and equipment sold to Bell Companies had been reduced again and again, so that the level of such prices prior to July 1, 1929, was only 70% of what it had been on January 1, 1923 (Exhibit A-51; II, 805). These reductions were due (1) to the

fact that Western consistently kept its prices down so that it would earn only a moderate profit on its Bell business; (2) to its planning its business ahead, based on estimates of requirements furnished in advance by Bell Companies; and (3) to the economies and increased efficiency permitted by the increasing volume of Bell business. In the spring of 1929 the current estimates of Western's Bell business for the year taken with the indications of an increased volume for 1930 led Western to announce a further reduction in the prices to Bell Companies of certain new apparatus and equipment, effective July 1, 1929. By the fall of 1930 it was clear that the increased volume of Bell business in anticipation of which prices had been reduced on July 1, 1929, and which alone could justify that reduction, would not be realized in 1930 and that the volume of that business for 1931 would be still lower. Therefore, effective November 1, 1930, Western changed its prices on certain apparatus so as to restore the overall level of its prices to approximately that which had been in effect prior to 1929 (I, 146-151). The prices thus established (with minor adjustments to cover certain increases in taxes and freight rates) were used in the reproduction cost estimates made by the Company as of December 31, 1932, and of December 31, 1933, and were received in evidence in this case (I, 222).

In the Court below the Commission contended that $1,500,000. (that being the measure of the effect of using the November 1, 1930, prices rather than the prices prevailing prior to that date) must be deducted before any weight could be given to the Company's reproduction cost study. In its opinion the District Court said that "the only specific complaint made by the Commission about Western Electric prices is that the Company's estimate of reproduction cost is based on the *present prices* of

'Western Electric which include a raise in the prices of about 10% effective November 1, 1930." (I, 567). Without deciding the point, the Court below, for purposes of the comparisons which it made, gave effect to the Commission's contention and eliminated this $1,500,000. in arriving at the figure for reproduction cost to which it gave evidentiary value. It is clear, therefore, that no issue is before this Court regarding the November, 1930, price change.[9]

The District Court's elimination of the effect of the 1930 price restoration left before it a reproduction cost estimate based upon Western's prices for new telephone apparatus and equipment at the level to which they had been reduced on July 1, 1929. The uncontradicted evidence established that such prices were the lowest Western had had since January 1, 1917 (Exhibit A-50; II, 804) and that they were 8.6% below those in effect at the end of 1928, 18.9% below those in force at the end of 1927, and 23% below those of the end of 1926 (Exhibit A-20; II, 665). The evidence also established that these prices were at the valuation dates—December 31, 1932, and December 31, 1933—substantially below the then prevailing outside market prices for comparable items (II, 678), and that Western, doing business at the higher 1930 prices, had made a large loss in each of the years 1932 and 1933 (I, 141; Exhibit A-17; II, 661), and was expected to make a further loss in 1934.

The Commission now criticizes the use of Western's prices, even as of the 1929 level, in determining reproduction cost of the Company's property as of December 31, 1933, and asks this Court to hold that the District Court erred in the weight it gave to said reproduction

---

[9] The 1934 price increase was not reflected in book costs or in the estimates of reproduction cost considered by the District Court. Such price change is not an issue before this Court.

cost estimate, upon the following grounds, each of which we discuss as we state it:

The Commission argues (Commission's brief, p. 131) that the evidence, which is undisputed, that Western's prices were substantially lower than the outside market prices at which comparable articles could be had on December 31, 1933, is insufficient in law because (1) the outside market involved sales very much smaller in total volume than Western's sales to Bell Companies, (2) because the outside market was not really a competitive market, and (3) because of Western's relationship to the Bell System.

The District Court overruled these contentions as it was required to do by the undisputed evidence before it.

That evidence established that the apparatus business of telephone companies outside the Bell System was substantial in volume, being the purchases of a large number of telephone companies in this country, having a total of about 3,000,000 telephones, having total assets of about $500,000,000 and having revenues of approximately $150,000,000 per year; that the market was competitive and was supplied by four manufacturers, and by one distributing company which purchased apparatus from Western at prices as high or higher than Western's prices to Bell customers and resold such apparatus in the outside field in competition with said four manufacturers; that Western's Bell prices were substantially lower than the outside market prices (I, 167-172); and that Western passed along to the Bell companies all the savings incident to the manufacturing advantages resulting from the Bell System relationship (I, 146, 157).

The District Court did not hold nor do we contend that these comparisons can be made for all the types of apparatus that are used by the Company, or that this evidence of higher outside prices is conclusive as to the propriety

of using Western's prices in reproduction cost estimates, but we do say that the trial Court was clearly right in holding that the comparison had evidentiary value. The comparisons were fairly made and included the prices of all articles which were comparable. The evidence covered a wide variety of commonly used articles and developed all of the comparisons which could be made as the telephone business is conducted in this country.

The Commission further contends (Brief, p. 126) that the use of Western's prices (even as reduced by subtracting the 1930 increase) in estimating 1932 and 1933 reproduction cost results in too high a figure. It says that the subtraction from the Western prices actually in effect on December 31, 1933, of the increase which was made in 1930, merely results in going back to the prices which were made effective July 1, 1929, and that Western's prices should have been much lower in 1933 than in 1929. This, the Commission says, is because general price levels, as shown by various indices, were substantially lower in 1933 than in 1929. The argument ignores the fact that in giving weight to Western's 1929-1930 prices, instead of to the higher prices actually prevailing in 1933, the lower Court was using the very lowest Western prices which had been in effect for 17 years (Exhibit A-50; II, 804). It further ignores the fact that Western's 1929-1930 prices had reached this low level as the result of repeated reductions made over a period of years when the general price levels with which the Commission makes comparison were rising or remaining constant (I, 145; 159; Exhibit A-20; II, 665; Exhibit A-50; II, 804). It ignores entirely the long continued manufacturing and purchasing arrangement conducted on a price basis which was in effect cost plus the very moderate profit margins established by the evidence in this case (Exhibit A-17; II, 661). And especially

does it ignore the problem of dealing fairly with a manufacturer who conducted its business on that basis, and, having made provision, by large additions to plant, increases in personnel and commitments for raw materials at prices then prevailing, to meet the increased requirements forecast by its customer (the customer in turn being under legal obligation to meet the demand of the public for increased telephone facilities)—and this during and prior to 1929—finds that customer's demand shrinking overnight and it as a manufacturer saddled unavoidably with increased costs as the requirements of the Company and other similar customers shrank progressively after 1929 (I, 136, 138, 157).

The relationship is not casual, it is permanent and stable and has continued more than fifty years. If it were casual, or if Western had in past years made high profits out of which it might have provided large reserves for such a contingency, there might have been some element of fairness in the Commission's point. The facts, however, and they are fully shown in the record in this case, establish clearly that no such profits have been made, and that the Commission's position, if sustained, would result in gross injustice to Western, and for the long run, in prejudice to the Company and its subscribers.

Furthermore, the Commission's argument ignores the actual facts of the situation. An estimate of reproduction cost must present, as nearly as may be, the costs which would actually be incurred if the plant were to be replaced at the time of the inquiry. The materials required would have to be purchased from Western or the other manufacturers above referred to. As long as the price advantages of buying from Western continue, the Company would, of course, continue to buy there. If a reproduction cost is to have reality it must therefore

start with the cost of such materials obtained from Western, i. e., with Western's prices at the time. So far as costs of materials are concerned an estimate based upon such prices would establish what it would cost to reproduce the Company's property. There is no dispute about this on the record. The only question remaining is whether or not the estimate would be entitled to weight as evidence of value in a confiscation case, and this in turn reduces to a question of what is fair, considering all the circumstances, to the rate-payers and to the Company.

We submit that the District Court was clearly right in its decision that, on the record before it, such use of Western's prices was not unfair to the public and that estimates based on such prices must be given the weight which reproduction costs should carry in determining the value of the Company's property. If the lower Court made any error, it was in the elimination of the $1,500,000. above referred to, but that of course is not under review.

Western has acted for the Bell System as manufacturer since 1882 and as purchasing agent since about 1906 (I, 133, 165). The high quality of its products, the efficiency of its manufacturing and purchasing operations, and the general advantages to the Bell Companies and the public of the Western Electric relationship have been so thoroughly presented to this Court in several telephone rate cases considered by it in the last few years that we shall not here review the evidence on those points. These points have heretofore been fully recognized by the Maryland Commission and in this case were referred to with approval by the Commission's principal witness (I, 410-411).

The evidence of Western's total business, its Bell business, its profits on all its business and on the Bell

and non-Bell parts thereof respectively, its profits on sales to Bell customers expressed as a percentage on its gross investment and on investment less depreciation reserve, and its profits as compared with those of other large manufacturing companies, were fully presented at the trial (Exhibits A 13 to A 19 inclusive; II, 660A-664; I, 159). The evidence was received without any objection thereto from the Commission. The exhibits and testimony covered the period 1916 to 1933 inclusive.

The foregoing proof was offered in pursuance of the decision by this Court in *Smith vs. Illinois Bell Telephone Company*, 282 U. S. 133, 152-3, under which the Company was required to show Western's net earnings from sales to Bell Companies and the extent to which such profits entered into the estimates upon which charges of confiscation were based. During the years 1932, 1933 and 1934, which were the important years in the minds of both the Commission and the lower Court, Western suffered losses, and so *no profits entered into the estimates* upon which the charges of confiscation were based.

Exhibit A-17 (II, 661) shows that for the period 1916 to 1932, inclusive, Western earned a profit on its average actual investment in its Bell business of 5.8%. The average investment upon which this return was computed excluded any amounts for patents, goodwill, development expense, or going concern value (I, 140). The return for this same period on the investment less the depreciation reserve was 7.5% (I, 159). During this period there was only one year, 1932, in which Western suffered a deficit. If the period were extended to include 1933, in which a deficit larger than that in 1932 was suffered, and 1934 in which another deficit was anticipated at the time of the trial, the average profit would, of course, be considerably diminished.

Exhibit A-18 (II, 662) shows that eighty-eight comparable manufacturing companies over the period 1925 to 1932 earned a return of 9.3% on their investment. This is comparable with 6.1% for Western on its Bell business for the same years (Exhibit A-17; II, 661). Exhibit A-19 (II, 664) shows that for the same period thirty-eight comparable manufacturing companies made a profit of 10.1% on sales as compared with a profit of 4.5% on sales made by Western during the longer period.

The Commission criticizes (Brief, p. 136) the inclusion of profit on sales, averaging 4.5%. The weight to be given profit on sales in considering reasonableness of prices is perhaps small, but the evidence was not offered to establish that point. It was offered because, when profit is made by Western, the profit on sales measures the extent to which the profit appears in the accounts of the company which purchases from Western.[10]

Western, by its contracts above referred to, is obliged to provide facilities for manufacturing telephone apparatus and cable to meet the requirements of the operating companies (which in turn reflect the demands of the public for telephone service, which it is the obligation of the telephone companies to meet) and to sell its products to those companies at prices which are both uniform and reasonable.

In performance of the first branch of this obligation, and while its Bell business was increasing from $188,159,000. in 1923 to $372,384,000. in 1929, Western acquired land and built two new manufacturing plants at Kearny, New Jersey, and Point Breeze, Maryland (I, 138, 148). These and the additions made during the

[10] If Western had made any excessive profit during the period in question, it would be a part of 4.5% of the book cost of the material obtained from Western which in turn comprises about 52% of the total of the Company's inventory (I, 423). If Western had made any excessive profit, (the record shows it has not) the maximum effect would be a corresponding part of 2¼% (i. e., 4.5% of 50%) of the book cost.

same years at the main works at Hawthorne, Illinois, accounted for a large part of the increases in Western's average investment applicable to Bell business from $131,504,000, in 1923 to $196,801,000, in 1929. Coincident with this expansion of facilities and increased investment required to meet the demands of the Bell System, including the demands of the Company, Western increased the efficiency as well as the volume of its operations, and passed the advantages thereof along to the Associated Companies by a series of reductions in its prices. The record establishes the following:

Year	Average Investment Devoted to Bell Business	Bell Sales	Rate of Profit on Investment Bell Business	Level of Apparatus and Equipment Prices
1923	$131,504,000	$188,159,000	4.8%	100%
1924	157,408,000	233,300,000	6.9	98
1925	159,942,000	226,700,000	10.2	95
1926	155,172,000	247,203,000	8.3	89
1927	160,498,000	241,062,000	10.4	84
1928	153,672,000	267,808,000	11.8	76
1929	196,801,000	372,384,000	9.1	70
1930	262,850,000	338,830,000	4.6	69
1931	262,717,000	219,535,000	4.2	75
1932	249,972,000	112,497,000	(3.0)	75

The foregoing figures are taken from Exhibits A-17 and A-31 (II, 661, 805) prepared and explained by the witnesses Crosland and Cox, and certified by the firm of Arthur Young & Company, certified public accountants (I, 141, 145). Formal proof of such certification was waived by counsel for the Commission, (I, 153).

The Commission's brief (pp. 137-138) argues that the dividends received from Western by A. T. & T. between

1924 and 1932 prove that Western made enormous profits. The argument rests upon the claim that a special dividend of $48,000,000 paid by Western to its stockholders in 1927 reflected profits made subsequent to 1923, and therefore the argument runs counter to the undisputed evidence. Since 1881 Western had done business through subsidiaries in many foreign countries. In 1925 it sold that foreign business. The $48,000,000 special dividend included the $15,000,000 profit made on that sale, and the aggregate of the earnings in this foreign field since 1881. They were clearly non-Bell earnings (I, 160-161, 549-520).

The Commission's brief also presents a table (p. 135) which purports to show larger profits made by Western than by other leading industrialists, and argues the point (pp. 134-137). The question at issue was Western profits on its Bell business. It needs no argument to show the error of the Commission's attempt to use Western's earnings on its entire business, in making its comparison. The Commission's comparison's grossly overstate Western's earnings and are unfair in other respects as shown fully in the exposition thereof by Mr. Crosland, General Commercial Accountant of Western (I, 516-20, Exhibit A-53, II, 807).

The evidence establishes, we submit, that Western has never made an unreasonably high profit on its Bell business. They also negative the possibility of any unfairness to the public in the lower Court's use of Western's prices in arriving at cost of reproduction. The viewpoint of the Commission is made plain in the testimony of its Chief Auditor (I, 437-439), who in answering questions of the District Court said in effect, that although Western was not "gouging" the public, it was compelled to continue doing business with the telephone company at increasing losses. The evidence shows beyond dispute that the relationship has not been abused, that the

plant held by Western was provided at the instance and within the demands of the Company and the other operating companies similarly situated, that Western did not make high profits during times of great general business activity, that its prices in question would not return it any profit for the year with respect to which they were used by the Court below, and that such prices were lower than prices available from others for comparable articles.

The Commission also criticizes Western's prices on several more limited grounds.

It says Western has a position of monopolistic power and can raise prices at will (Brief, p. 124). The test is not one of theoretical power, but is rather that of what has actually happened. Every citizen has the power to commit murder but that does not establish that he has done so. The evidence is contrary to the Commission's assertion. The existing system of public regulation of Western's Bell customers throughout the country is further and adequate insurance against unfair practices.

The Commission says (Brief, p. 132), that Western's accounts do not show its costs, item by item, for products manufactured. That is the fact but it does not affect the issue. Western's books reflect its business completely and accurately. They afford all the information necessary to establish the facts on every question raised in the case regarding Western's prices. The information was assembled and the necessary computations and exhibits prepared by Western's accounting department. The methods used and the results were checked and certified by certified public accountants, (I, 141, 152).

Western makes many thousands of different articles. Theoretically, costs could be accounted for, item by item, but such accounting would serve no practical purpose,

would be very complex and burdensome and would merely increase Western's costs of doing Bell business, and therefore its prices to Bell Companies, by the costs of such accounting in a business of the magnitude and complexity of Western's.

In this connection the Commission criticizes Western's use of a "Standard Cost System" of accounting, and the fact that Western has saved money by not revising its Standard Costs during the last few years. The criticism has no merit, once it is understood that the "Standard Costs" are used in current accounting as a means of checking and controlling efficiency of manufacturing operations. At any time it is desired to make such a check, or to use the Standard Costs in other ways (for example, as a basis of apportioning to Bell and non-Bell business certain expenses not directly allocated on the books) a special study is made and at that time full recognition can be and in this case was given to the differences in prices of raw material and other variations from the costs of such items as they were when Standard Costs had last been revised (I, 156). It must not be forgotten that the figures *used in computing* Western's profits (Exhibit A-17; II, 661) were the actual revenues and the actual costs of the Company, and that the "Standard Costs" were used only as an aid in the necessary apportionments thereof between Bell and non-Bell business.

The whole problem of the apportionment in this case is to divide on a substantially accurate basis between Western's Bell and non-Bell business the property which is used in the manufacture of Western's products, such as plant and machinery, and to apportion correctly between the two businesses the cost of manufacture, including labor and materials, all on the basis of relative use. The "standard shop costs" furnish an accurate basis for such an apportionment.

The reliability of the methods and the accuracy of the results were certified by Arthur Young & Co. (I, 141, 152).

The Court below overruled the Commission's objections under discussion and was, we submit, clearly right in so doing.

Telephone Company's Labor Costs.

The Commission contends that the cost of labor used in the Company's appraisal was greatly in excess of its market value. (Commission's Brief, p. 140).

The Company's estimates of reproduction costs new reflected labor costs developed from the Company's experience and adjusted downward for wholesale or large construction work (I, 223).

Reduced to fundamentals the point made by the Commission with respect to labor costs is clearly shown in two exhibits A-46 (II, 800) and Exhibit D-5, p. 48, (II, 860-A).

For the years 1929 to 1932 the upper curve on each of the four charts appearing on Exhibit A-46 may be compared with the two curves shown on the chart from Commission's Exhibit D-5, both of which reflect a wage rate of about $1.27 per hour in 1929, a slightly higher rate in 1930 and then a sharp drop to about $.90 per hour by the latter part of 1932. The drop is about 30% from the 1929 figure.

The lower curve on each of the four charts of Exhibit A-46 reflects the Company's experience with average wage rates of about $.80 per hour in 1929, increasing to about $.84 in 1930 and to about $.87½ in 1931. It held fairly constant at that rate through 1932. There have been no increases in the wage rates since 1930 and the slight increase in the Company's average wage rate from 1929 to 1932 is explained in the record (I, 375, 223). It

is due, as Mr. Smith recognized (I, 417), not to increase in wages paid, but to the fact that when construction work fell off, the Company first let out the people of short terms of service who were, of course, in the lower wage brackets. That left a higher proportion of long-time employees and so operated to lift the average wage rate.

The Commission's position is merely that any evidence of value in this case must, in so far as wage rates are concerned, show about a 30% drop from the levels of 1929. It compliments the Company on its wage policies but says that the actual cost of construction resulting from the application of those policies cannot have evidentiary value for the reason above stated (Commission's Brief, p. 142).

Wages represent roughly 35% of the cost of the plant (Commission's Brief, p. 141). The evidence established that the labor costs used in the Company's studies were substantially lower than the Company's actual labor costs in 1932 and 1933. Mr. Speer, the Company's Chief Engineer, was fully cognizant of the fact that the average wage rates of 1932 were not representative of normal construction conditions and in arriving at reproduction cost he adjusted the 1932 average wage rate to reflect the effect of putting existing forces back to work on a full-time basis and of augmenting those forces with a normal number of temporary and semi-skilled employees at lower wage rates (I, 223). The Commission's Brief refers to this adjustment but insists that it did not go far enough, though it may be noted that this adjustment was what Mr. Smith thought would be proper (I, 409-410, 417).

The Commission's brief seems to disclose a lack of understanding of the adjustment made by Mr. Speer, for it ignores the adjustment made to conform his labor costs

to a *wholesale reproduction program* (I, 223). The joint effect of the two adjustments made by Mr. Speer was that the labor costs used in the appraisal were considerably less than the labor costs current in 1932 (I, 223).

It is also suggested in the Commission's brief (p. 141), that the 1930 installation labor costs of the Western Electric Company were used by the Company for the purpose of eliminating from the final result the effect of a 10% reduction in wages made in 1933. This suggestion ignores the testimony of Mr. Crosland, that the reduction was restored after a few months because of the National Industrial Recovery Act (I, 151). Mr. Speer explained why such 1930 installation labor costs were used, as follows (I, 228):

> "I took into consideration the fact that the Western Electric installation forces are more or less localized and operate on a district basis, and that during the year 1929-30 in this district the Western Electric was doing for the four Chesapeake and Potomac Companies about the same volume of work that they would have had to do in a reproduction of this property in any one year."

The Commission's own witness, Mr. Smith, testified as to the labor costs which should be used in the reproduction cost estimates as follows (I, 409, 410):

> "There is not any reason why a public service corporation which keeps up its rate of payments to labor, should have the value of its property depreciated on the theory that it ought to have cut the price paid to its labor. * * * As to whether the price paid for its labor in construction fixes the construction price of labor for that company, it does fix the price where the company is doing large construction work."

It is clear from its opinion (I, 548-549; 7 F. Supp. 224) that the District Court understood how the Company

determined its labor costs and overruled the Commission's contention and we submit that the conclusion of the District Court was fully sustained by the evidence.

Undistributed Construction Costs.

The Commission contends that the District Court erred because the estimates of cost of reproduction which that Court took into consideration included excessive amounts for undistributed construction cost. There was not in the Court below and there is not here any question about the reality of this as an item of cost of reproduction, or about the fact that such costs include engineering expense, administration and legal expenses, contingencies, and interest, taxes and insurance during construction. These items can best be determined as a whole and they are applicable to the entire property rather than to particular units of plant. (I, 241).

The argument of the Commission is concerned primarily with interest during construction, which it condemns because the amount included in the estimates is substantially larger than the amount shown on the Company's books for this item (Commission's Brief, p. 139). The record makes it plain that under the accounting rules prescribed by the I. C. C. and adopted by this Commission interest during construction is accounted for separately, and therefore appears on the Company's books only in connection with large construction projects which have been undertaken since 1918 and which have required more than sixty days for completion (I, 200). It is obvious that in a reproduction program all plant would be subject to interest during construction at some time and that comparisons between the amount shown on the Company's books and the amount included in the estimate of cost of reproduction on account of interest

during construction can have no force (See Mr. Barker's clear explanation of this—I, 242).

The uncontradicted evidence shows that about six years would be required for the economical reproduction of the Company's property. The amounts included in the estimates of reproduction cost on account of interest during construction aggregated 5.5% (less than one year's interest at 6% per annum) of the direct cost (I, 255; 263-265).

The evidence of the Company's witnesses, Mr. Speer and Mr. Sloan; and they were corroborated by Mr. Barker, show clearly that the estimates were based on substantial Company experience and actual expenditures made in connection with the large construction projects it has had (I, 229-32; 243-44; 262-65). The Commission's Brief ignores this evidence.

The Commission also says that the amount included for contingencies and omissions merely provides for errors, etc., in engineering judgment (Brief, p. 140). This again is merely a statement contrary to the evidence. The item of contingencies refers to physical conditions which cannot be foreseen and therefore which cannot be provided for in the unit cost. And again the Company's witnesses explained the item fully and related the amounts they used to the Company's experience (I, 230, 241).

We submit that the amounts included in the estimates of reproduction cost on account of undistributed construction cost were properly ascertained and are reasonable (I, 243, 255); they were sustained by substantial evidence; and the District Court did not err in holding (I, 550) that: "as a whole they are not excessive" in a reproduction cost estimate.

Buildings.

The Commission argues (Brief pp. 106-108) that amounts included in the estimate of reproduction cost of buildings in Baltimore and large buildings outside of Baltimore are excessive.

Except as to the buildings covered by the stipulation (I, 96), the Company's estimates of reproduction cost (p. 59, *supra*), were developed by admittedly experienced and practical builders. The appraisals were worked out in great detail, the results thereof being shown in the Company's Exhibit A-9, as of December 31, 1932, and Exhibit A-10, as of December 31, 1933 (I, 630, 636). Each building was treated individually, being broken down into its component parts and unit costs determined for each component part.[11]

During the trial of the case, in answer to questions from the District Court, counsel for the Commission stated that there was no dispute as to the standard methods followed by these witnesses, and thereupon the Court stated that if cross-examination rendered it necessary the Company could develop its methods further (I, 123). At no time was any criticism made, nor was any cross-examination directed to the methods used by these witnesses or to the accuracy of the estimates of the reproduction cost new of the Company's buildings.

The Commission contends (Brief, pp. 106-107) that a comparison of the reproduction cost estimate made by the same witnesses in 1923 with the estimates in the present case shows that the present estimates are excessive.

---

[11] The several sheets of the exhibits contain detailed information as to the various individual buildings, being identical in form with Sheet 10 of each exhibit printed in the record (I, 633-634; 641), but in accordance with the stipulation as to certain exhibits, have been omitted from the printed record (II, 1100-1101).

The two estimates are not comparable.

The 1923 building estimates were based upon average unit costs derived from a study of certain buildings. The District Court (3 F. (2d) 938, 949) criticized those estimates because the average unit costs were applied to all buildings. The estimates in the present case did not rest upon the averages condemned in 1923, but dealt with each building individually (I, 122, 633, 641).

Furthermore the buildings appraised in 1932 were not (the Commission erroneously states the contrary in its brief, p. 107) the same as those which had been appraised in 1923. New buildings had been added and others retired. During the ten years the Company's investment in buildings had doubled.

Mr. Smith also made a comparison between the two estimates for a single building which was in use in both 1923 and 1932. The building he selected was one to which the 1923 average unit costs would not apply: The comparison is meaningless for reasons stated above.

This indirect attack on the credibility of these experienced building witnesses should not be given credence in the absence of stronger evidence than has been put forward. No questions were addressed to these witnesses as to any discrepancy between the 1923 appraisal and the present appraisals, and this is particularly significant in connection with Mr. Cummins, who would, of course, have been subject to cross-examination as to a comparison of his estimate of reproduction cost with the results of his own construction index. We suggest that no questions were asked of these witnesses because the *Commission and its counsel were well aware that the methods criticised by the Court in* 1925 *had not been used in the present appraisal.*

VI.

DEPRECIATION ANNUITY OR EXPENSE.

The District Court's allowance of $2,000,000 for the expense of depreciation for the year 1934 is amply sustained by the evidence.

The Court's fourth Finding of Fact is as follows:

> "4. We find a reasonable and proper allowance for depreciation expense from the whole revenues of the plaintiff (both intra and interstate) will be $2,000,000 for 1934" (I, 584; 7 F. Supp. 216).

The Court supports this finding in a lucid discussion in its opinion under the above caption (I, 573-580).

The Company's claim for this item of expense was $2,173,000. This claim was supported in detail by the testimony of Mr. Gompf, the Company's engineer, and Mr. Woodford, of the engineering staff of the American Telephone and Telegraph Company.[12]

The Commission's allowance, corresponding to the amount claimed by the Company, was $1,720,724.[13] The Commission's witnesses were two general engineers, Messrs. Pagon and Holland, who also gave detailed testimony on the subject.[14]

Both the Company and the Commission profess to adhere to the straight line method of depreciation accounting as prescribed by the Interstate Commerce Com-

---

[12] See opinion, I, 573-75. Gompf, I, 310-339. Woodford, I, 339-353. Company's exhibits: A-4 (I, 909); A-38 (II, 769); A-39 (II, 775).

[13] This is the amount of the depreciation charge based on the cost of the plant as shown by the books, which the Court found as the value of the property. When the Commission's depreciation rates are applied to the Commission's valuation the amount is $1,352,284, and this is the amount the Commission is contending for on this appeal. (Commission's exhibit D-14, II, 921; Commission's brief, p. 12). See on this point the opinion of the Court (I, 573-574); also Record I, 388.

[14] Opinion, I, 573-574. Holland, I, 474-488; Pagon, I, 490-514. Commission's exhibits: D-19 (II, 1089); D-21, (II, 1091); D-7 (II, 876); D-14 (II, 921).

mission, with which this Court is thoroughly familiar, and to be governed by the definition of depreciation as stated by the Chief Justice, speaking for the Court, in the Chicago rate case, *Lindheimer v. Illinois Bell Telephone Company*, 292 U. S. 151, as follows (p. 167):

> "Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year. In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is, in the cost of producing the service, an allowance for consumption of capital in order to maintain the integrity of the investment in the service rendered. The amount necessary to be provided annually for this purpose is the subject of estimate and computation. In this instance, the company has used the 'straight line' method of computation, a method approved by the Interstate Commerce Commission. 177 Inters. Com. Rep., pp. 408, 413. By this method the annual depreciation charge is obtained by dividing the estimated service value by the number of years of estimated service life. The method is designed to spread evenly over the service life of the property the loss which is realized when the property is ultimately retired from service."

The District Court made its determination upon the same basis, citing and relying upon the Lindheimer and other decisions of this Court. *There is therefore no issue in this case concerning the fundamental principles to be applied in arriving at the correct amount of this item of expense.*

Under this method the expected service lives and salvage, from which the annual depreciation rates are directly derived, are determined separately for the several

classes of plant as classified for this purpose by the accounting rules of the Interstate Commerce Commission, and all of the evidence on both sides, as also the Commission's computations, purports to follow this procedure. From these class rates, weighted in accordance with the correlative dollar quantities of plant in service, the equivalent composite rate applicable to the property as a whole may be computed, and this has been done here.

The composite of the several class rates of the Company, which produced the sum of $2,173,000, claimed by it, is 4.38%. (I, 574; 7 F. Supp. 235; Exhibit A-4, I, 609).

The corresponding composite rate of the Commission, which results in its allowance of $1,720,724., is 3.45%. (I, 574; 7 F. Supp. 235).

The Court found a composite rate of 4%. This when applied to the plant then in service of $50,000,000. gave the sum of $2,000,000. found by the Court.

It appears, therefore, from the foregoing outline of the facts that the parties to the suit were squarely at issue upon a purely factual question, with respect to which there was much conflict in the evidence of the opposing sides. The District Court was called upon to sift, analyze and weigh this evidence and from it to resolve the question and make its own special finding, having due regard to the nature of the subject and of the evidence, much of which was of a technical and expert character, and to the applicable law respecting the burden of proof as it has been announced by this Court. This the Court did.

The Commission in its brief, (pp. 29-49) contending that upon the record the Court was bound as a matter of law to accept the Commission's allowance for this item, makes a threefold attack upon the Court's allowance of $2,000,000., asserting:

(1) That the Court misconceived and misapplied the law with respect to its own function and authority in the premises and with respect to the proper definition of the burden of proof;

(2) That the finding of the District Court is arbitrary; and

(3) That in any event the evidence is insufficient in law to sustain the finding.

We will consider these points in the order stated.

First: The District Court correctly understood and applied the established principles of law.

The Commission's brief devotes many pages to a discussion of the law in an effort to show that the District Court "misconstrued the burden of proof in such cases and the resulting scope of its power to substitute itself as the rate-making body" (Appellant's Brief, pp. 40-41). In replying to this argument, it does not seem to us necessary to discuss the many cases cited and relied upon by the Commission.

In the section of its opinion devoted to this question the District Court cites the following cases: *Lindheimer v. Illinois Bell Telephone Company*, 292 U. S. 151; *Clark's Ferry Bridge Co. v. P. S. C. of Pennsylvania*, 291 U. S. 227; *Smith v. Illinois Bell Telephone Co.*, 282 U. S. 133. The District Court therefore had knowledge of the authoritative decisions of this Court, including what were then its most recent pronouncements. That it was familiar with these decisions, and that it did not misconstrue them, as contended, but on the contrary read them correctly, is demonstrable on the face of the opinion.

In the depreciation expense section of the opinion the Court opens the discussion with the statement that "it is necessary to determine from the evidence the probable net earnings of the plaintiff for the coming year" (1934),

and thereupon proceeds immediately with the discussion of this item of expense in relation to that ultimate issue. The Court says (I, 575, 7 F. Supp. 235):

> "As the issue in the case is confiscation, the burden of proof is on the company to *convincingly demonstrate the necessity* for the larger allowance from revenues for depreciation expense than that allowed by the Commission." (Italics ours.)

Later in the same section of the opinion, referring to *Lindheimer v. Illinois Bell Telephone Company* (Chicago Telephone Case), the Court says (I, 579, 7 F. Supp. 237):

> "The principle announced and applied was that in a rate case where the rates fixed by the public authority are not in fact confiscatory unless the total amounts charged to depreciation expense by the company can be established as necessary, the burden is on the company to *convincingly demonstrate the necessity* for the amounts annually charged by it to depreciation expense." (Italics ours.)

We suggest that the Company might fairly complain that the District Court applied too severe a rule against it, a rule more strict and burdensome than this Court's pronouncements can fairly be said to justify, when it required a convincing *demonstration* of *necessity* in order to overturn a finding of fact made by the Commission, especially since the evidence against the Company was that of the Commission's own witnesses.

The rule of law for which the Commission contends in its brief would be harsh indeed, and would come perilously near to nullifying the due process clause of the Fourteenth Amendment, if it would not as a practical matter actually do so. The Commission in its brief does, it is true, acknowledge that the *letter* of the law is that this case is to be decided by the Trial Court upon *its own independent judgment of the law and facts.* The Com-

mission admits in theory that the question of confiscation is to be decided under that rule. But that principle is devoid of any meaning unless it is to be carried back to the determination of the facts upon which the question of confiscation necessarily depends.

Second: The finding of the District Court was not arbitrary, as contended by the Commission.

The Commission's brief, in the headnote on page 29, characterizes this finding as "the Court's arbitrary finding of $2,000,000." It is argued that the "roundness" of the Court's figures lends credence to this denunciation of its finding as being arbitary. (Commission's brief, p. 40). It is true that, to be exact, the base to which the rate of 4% should have been applied was $50,025,278 (I, 576, 7 F. Supp. 236), and the Court rounded this to $50,000,000 (I, 578, 7 F. Supp. 236).

The Commission also argues in its brief (p. 48) that the action of the District Court was arbitrary because of its failure to find separate depreciation rates for the several classes of property, and thus to reach a meticulously accurate result. In order to do that it would have been necessary for the Court first to find the service life and salvage for each class of plant, since there is no other way to determine the exact rate on the straight line basis. Undoubtedly, in the circumstances above stated, it was incumbent upon the parties to follow this method. But the Court was sitting in a judicial, not in an administrative, capacity. It was under no duty to fix separate depreciation rates for the many classes of plant, to be charged in the Company's accounts, and to do so would have been outside its proper function. The Court's task was to determine from all the evidence the reasonable and proper sum of money to be allowed as a charge to expense for this item, and this it did in the manner and upon the considerations stated in its opinion.

The Court's finding was in no sense arbitrary, and the best evidence of this is its patient, painstaking, and judicial discussion of the subject in its opinion.

Third: The District Court's finding is fully sustained by the evidence.

The Company inaugurated depreciation accounting in 1907 (II, 979). The Maryland Commission was not created until three years later, and it was at about the same time that telephone companies were first made subject to the Interstate Commerce Commission. In 1912 the Interstate Commerce Commission prescribed a Uniform System of Accounts for Telephone Companies, effective January 1, 1913, and this system of accounts provided for and required the method of straight line depreciation accounting which has continued in force substantially unchanged, and entirely unchanged so far as the basic principles are concerned, to the present time.

In 1914 (as of June 30th), a depreciation reserve of $1,367,700 had been accumulated (II, 969), which was approximately 10% of the plant investment (II, 973). In the rate case before the Commission begun in 1913 and decided in 1916, Case No. 690 (Exhibit D-15, II, 923), the Commission found that the property was depreciated 20% and deducted that amount in arriving at the value upon which the Company would be permitted to earn. The Commission arrived at this finding of 20% depreciation by the theoretical age-life method (II, 977-978). The Company's evidence in that case showed that the property was depreciated 10.77% (II, 973). The Commission recognized the hardship to the Company in this method of valuation and held that it should be allowed gradually to build up a reserve of 20%. In this connection the Commission said:

> "Of course it cannot be expected that a depreciation reserve of 20 per cent. of the plant investment

would remain at that precise percentage for any appreciable period of time, for the very object and purposes of the reserve presupposes that it will fluctuate from month to month with the necessarily erratic drafts thereon for replacements. Therefore when we speak of a 20 per cent. depreciation reserve we mean a reserve whose normal average maximum shall be approximately twenty per cent. of the total plant investment" (II, 968-969).

In the next rate case in 1920, the depreciation reserve was shown to be 16.88% and the Commission again deducted 20% for depreciation in arriving at the value of the property (Case No. 1709; II, 1029, 1039-40).

The last rate case prior to the present case was in 1924 at which time the reserve standing on the books was $6,022,854., and the Commission deducted $5,667,736., or 20% in arriving at the value. The telephone rates fixed by the Commission in that case were the subject of a confiscation suit in the Federal Court and were held to be confiscatory. The Commission did not appeal. The Court in that case computed the depreciation reserve, which had been invested in the plant, to bring it up to a level corresponding with the reproduction cost new of the property as then found by the Court, and deducted the amount so computed from the reproduction cost new in arriving at the value of the property.[13]

Since the 1924 case the depreciation rates determined by the Company from time to time to be proper have not been questioned by the Commission until the present case, (I, 430, 458). Plaintiff's Exhibit A-4 (I, 609) gives a complete accounting statement of the depreciation experience of the Company for the ten-year period 1924-1933, inclusive. As there shown (line 18) the annual de-

[13] *The Chesapeake and Potomac Telephone Company v. Whitman*, 3 F. (2d) 938. Immediately after the Court's decision the Commission held a new hearing and fixed telephone rates to yield a return in conformity with the decision.

preciation rate, composite, has fluctuated at a figure slightly above 5% (from 5.05 to 5.15%) during the first nine years of the period. The rate in 1932 was 5.15%. In 1933 a large reduction was made and the rate for that year was 4.38% (see footnote on the exhibit). This is the rate that was claimed by the Company in the present case.

These reduced rates produce a charge to expense for the year of $2,173,000., as already stated, or a reduction of $355,000 (I, 336). The District Court has made a further reduction of $173,000, or a total reduction in the expense for 1934 of $528,000. as compared with the 1932 depreciation rates. When computed on the same property valuation, namely book cost, the Commission contends for a reduction to the sum of $1,720,000. a reduction of $808,000.[16]

The reduction is brought about as the result of the business depression. In the telephone business expansion required to meet the demands of the public for service makes it necessary to retire existing plant and substitute other and enlarged facilities in its place. This factor of growth is of course only one among many factors terminating the life of plant, some of the other factors being obsolescence resulting from the rapid and continuous development of the art, which the Bell System promotes assiduously at all times; storms, such as the destructive sleet storms shown in this case and referred to in the Court's opinion (I, 577; 7 F. Supp. 236); public requirements, such as the laying out of new highways and changes in widths and grade; public insistence upon new types or methods of service and new styles of appliances; and the effect of the elements and of wear upon physical things. But in the Bell System growth

[16] As already explained in a footnote on page 83, *supra*, the Commission is here contending for an allowance of only $1,352,284., based on its lower valuation.

has been the largest *single* factor causing retirements, because of the rapidity with which the business has expanded.

The depression having interrupted this expansion, it became necessary for the Company to revise its depreciation rates to give effect to this changed condition (I, 313). In making this revision the Company was not at liberty, even if it had so desired, to reduce this item of expense on account of the depressed state of its earnings and with a view to making a better financial showing, as private concerns and some regulated utilities are permitted to and may properly do. The legal duty of the Company under the prescribed accounting rules which it may not violate, was to give full and proper weight to the cessation of growth as affecting the service life of the existing plant, and to determine the correct depreciation rate on the straight line basis to the best of its ability. For this purpose this Company and the Bell System have a wealth of accumulated experience, statistical data, and engineering talent trained in the telephone industry, as the record shows.

In the regular and ordinary course of business, therefore, the Company addressed itself to this problem and on January 1, 1933, put into effect reduced depreciation rates. The investigation was continued, and on April 1, 1933, a further reduction was made. The combined effect of both reductions represented a reduction in the composite rate from 5.15% for the preceding year to 4.38% for the year 1933, and in the expense item a reduction of $355,000., as already stated.

Upon the trial in the Court below, as well as before the Commission, the Company made a full and circumstantial showing of what it had done and the reasons for it, through the testimony of experienced telephone engineers.

On behalf of the Commission two general engineers, admittedly competent in their own branches of their profession, but almost wholly without experience in or knowledge of the telephone business, testified. These two witnesses for the Commission with commendable frankness acknowledged, or at least seem to have intended to acknowledge, their own difficulties and limitations when finding themselves in a strange field. Mr. Holland stated early on his direct examination:

> "I am not a technical telephone expert, and will not testify as such" (I, 473).

Mr. Pagon, the other Commission witness, testified:

> "First of all, I make no pretense of being a telephone man, and, as Mr. Holland has said, what I know of telephone equipment is from study, from observation, such as I have been able to make" (I, 504, see also 505).

Each of these witnesses made a full statement of his training and experience in order to qualify (Mr. Holland, I, 473; and Mr. Pagon, I, 488-490), and these statements show how utterly foreign to their training and experience was the subject about which they were undertaking to testify. Their experience had been confined to such engineering fields as steam and hydroelectric plants, industrial power plants, water works, paving and the like, in the case of Mr. Holland; and to bridges, paving, electric systems, sewerage, generating stations, gas holders and the like, in the case of Mr. Pagon. It is apparent that in these various lines of activity they could have learned very little concerning the serviceability and other pertinent characteristics of so highly intricate and specialized a property as a large modern telephone system.

It will not be necessary to burden the Court with any

extended discussion of the testimony of the Commission's engineers. We will only refer briefly to their treatment of two classes of plant, which will fairly characterize the whole of their testimony.

We refer to so-called manual buildings, which are the central office buildings housing central office equipment of the manual type, and to the manual central office equipment itself. These two classes of plant represent 22% of the total depreciable property of the Company (I, 317).

For these buildings as a group, the Company had determined an overall expected service life of forty years, with an average service life of twenty-seven years, and salvage of 15%, producing a depreciation rate of 3.1% (II, 775, 776A). The Company arrived at these results from a detailed study of the recorded life history of each building and upon the basis of a forecast for each building, as appears from the references to the record last given.[17]

For manual central office equipment, the Company had found the service life to be seventeen years, with 4% expected salvage, giving a depreciation rate for the class of 5.6%. The life was increased from twelve years to seventeen years in recognition of the effects of the depression (I, 327).

Turning now to the testimony on behalf of the Commission, Mr. Pagon testified to an estimated overall service life for manual buildings of 200 years, and for the manual equipment of 50 years, although in the case before the Commission he had said 50 to 75 years (I, 510-511). Since obviously the buildings and the equipment

[17] Since the buildings include various parts which have to be retired and replaced from time to time, such as heating plants, electric systems, elevators, and the like, and for other reasons shown by the record, the weighted average life of the buildings based on the dollars of costs or value which the buildings represent is much shorter than the overall life of the entire structure.

must be operated together, he was asked to explain how he proposed to deal with them as a practical matter in order to realize these service lives of 200 years and 50 years respectively, and his explanation was that he contemplated four complete installations of new equipment, "one original installation and three re-installations on that basis", each to last 50 years in service, thus spanning the 200 years the original building was to serve (I, 510-511). Being confronted with the difficulty (the impossibility) of continuing to give telephone service while one set of equipment was being removed and the new equipment installed, he is vague in his testimony, but nevertheless insistent that the difficulties can be surmounted and the service continued without interruption (I, 511). Mr. Pagon's exhibit (Exhibit D-21; II, 1091) does not show what his depreciation rate for manual buildings would be: he there combines manual and dial buildings (the latter being the latest development of the art and therefore of recent construction and prospective longer lives, as well as greater salvage); and for the combination he finds average service life of 100 years, salvage of 33%, resulting in his depreciation rate of 0.67%. These figures may be compared with the Company's findings above referred to. For the manual central office equipment he uses service life of 50 years with salvage of 4%, producing a rate of 1.92%.

When it is remembered that the telephone itself is only a little more than fifty years old, so that the development of the art from its crude beginning to its present state has taken place under our eyes, we naturally wonder how Mr. Pagon came to make such fantastic findings as he did. He explains this, and his explanation discloses both his lack of knowledge of the telephone business and his fundamental misconception of depreciation expense.

His conclusions are all based upon the assumed premise

that no telephone plant will ever again be retired because of obsolescence or inadequacy, both of which have in the past been very important causes terminating the life of plant, and the latter of which, inadequacy, has been the largest single cause. He declares "a moratorium of inadequacy and obsolescence" (I, 490-491; 503). His reasoning is that since the property is not now growing, due to the depression, and since inadequacy is due to growth, the factor of inadequacy must be wholly eliminated from consideration.

With respect to obsolescence he discovers that the telephone witnesses have heretofore testified in the depreciation hearings before the Interstate Commerce Commission and elsewhere that, although the telephone art is one of the most rapidly developing and changing arts, resulting in rapid obsolescence of existing plant, this factor has been largely inoperative to produce retirements, because inadequacy due to growth has supervened. That is, says the witness, the retirements have been the result not of the development of the art, but of the growth of the business. When the older types of apparatus are retired on account of inadequacy resulting from growth, then the new and improved types (which the development and research work of the Bell System, as well as of scientists and inventors in this and related fields all over the world) have produced, are substituted in the plant, and in this way the telephone system is re-created. Taking the premise as thus stated, the witness then makes two assumptions, both of which are fallacious or groundless: namely, first, that inadequacy will never again operate as a cause of depreciation (the depression will last forever); and second, that obsolescence cannot take place in the absence of expansion of the business. In this view, of course, obsolescence is never under any conditions an effective cause, the proximate cause, of depreciation of telephone plants (I, 490-514).

It is not to be understood that he thinks these things are actually true; he does not, and expressely disclaims thinking so. That is not the point, he says. The point is that growth is not currently taking place, and that therefore in projecting service lives into the future that condition should be assumed to be permanent. When the situation changes, as he apparently believes it will, then the depreciation rates are to be revised to take these factors into account. He seems fully to realize that his method is not calculated to spread the loss due to the consumption of the property in service throughout its life in equal, annual increments, as nearly as may be, which is the premise and basic principle of straight-line depreciation accounting.

The unreality of this testimony is apparent and does not call for any further comment from us. While Mr. Holland, the Commission's other expert witness, is not in complete accord with Mr. Pagon on all points, he is in general accord. He also throws out entirely all consideration of inadequacy and obsolescence, and for the same reasons (I, 474, 488).

It would unduly prolong this section of the brief for us to undertake to summarize the Company's evidence on this question, and, moreover, we think it is entirely unnecessary. We have already referred to all of that evidence with citations to the Record. The three Judges heard all of the witnesses and followed their testimony closely.

The Company employed the same methods in revising the depreciation rates in 1933 that had been in use for a great many years and by means of which depreciation rates had been found that were at all times satisfactory to the Commission. The methods are fully described in the testimony of Mr. Gompf. These methods have been approved as sound and have been highly commended by

the Interstate Commerce Commission in the telephone and railroad depreciation cases (see *Smith v. Ill. Bell Tel. Co.*, 282 U. S. 133, footnote on page 158). They were also expressly endorsed by the Commission's Engineer, Mr. Pagon, in his testimony in this case, who, referring to the work of Mr. Crumden of the Depreciation Accounting Staff of the American Telephone & Telegraph Company, said that he "deserves the credit for the remarkably complete, scientific and excellent studies that have been made in the past—they undertook to do it on the statistical basis" (I, 499).

Admittedly there has been no situation in the past exactly similar to that confronting the Company when it came to revise its current depreciation rates in the overlapping months of 1932-1933. But the changed conditions did not abrogate sound principles. Moreover, the experience of the Bell System, covering the entire country, has presented nearly all possible varieties of conditions with respect to the effect of varying rates of expansion of the business, ranging from a practically static condition to that of extraordinarily rapid expansion. Of course, the obvious truth of the Trial Court's statement in its opinion, referring to the estimates of the Company and of the Commission, that "both are only estimates for the future based on opinion evidence of experts" (I, 574), is recognized by us. The important thing is that it was recognized by the Court.

One further point remains to be considered, which was also the subject of careful deliberation by the Court below; namely, the fact that the depreciation reserve increased from 20.48% in 1932 to 22.97% in 1933 (Opinion, I, 576). This fact seems to be the Commission's main reliance for reversal in its brief herein. A brief discussion on our part will be sufficient, especially in view of the careful discussion in the opinion below.

The reserve percentage to plant for each of the years 1914 to 1932, inclusive, is stated on p. 68 of the Commission's brief as follows:

Year	*Per Cent.*
1914	14.77
1915	16.17
1916	17.89
1917	20.58
1918	19.50
1919	21.40
1920	22.55
1921	24.07
1922	24.58
1923	23.26
1924	20.84
1925	19.30
1926	18.67
1927	19.34
1928	20.03
1929	20.87
1930	20.08
1931	19.95
1932	20.46

The Court will observe that the reserve first reached 20% in 1917, since which year it has fluctuated between 18.67% and 24.58%. During all these years the Company's depreciation rates have not been questioned by the Commission. It is only necessary to take a glance at this table to see that there is nothing unusual or exceptional about the increase in 1933.

This reserve history is highly commended by the Commission. Speaking of this history, the Commission's chief auditor, Mr. C. W. Smith, testifying for the Commission, said:

> "It has a remarkable history for being stable, if we ignore the early years" (I, 429).

And referring to the fluctuation in the reserve, he further testified:

> "I have no special comment to make on the fact that from 1921, 1922 and 1923, the ratio of the reserve to plant was higher than 20%, being 23% or 24%, 22% and 24.58%. The reserve will fluctuate between a few points, depending on retirements and new construction work in any single year" (I, 429-430).

He then comes to the 1933 ratio of 22.9%, and with reference to that he says:

> "As to whether I would argue from this that the Company's depreciation reserve was too great in 1933, I am not sure about any one particular year, and it is awfully hard to tie down the depreciation reserve to a specific figure" (I, 430).
>
> "I think the history of this Company's depreciation reserve is a magnificent thing" (I, 430).

The foregoing testimony was presented to the Court on the part of the Commission upon the direct examination of the witness, a highly responsible officer of the Commission.

In the former suit in 1924, brought by the Company to enjoin the telephone rates then prescribed by the Commission, which were enjoined as being confiscatory by the special District Court of three Judges, the Court had occasion to deal with this question, and Circuit Judge Rose, writing the opinion in that case, *Chesapeake & Potomac Co. v. Whitman* (1925), 3 F. (2d) 938, has this to say (p. 953):

> "The situation of this Company itself illustrates how unwise it may be to assume that there is any real excess in depreciation reserve. In late years it has rapidly extended its business and has added greatly to its plant and equipment. A much larger propor-

tion of the latter is new than will be the case a few years after the rate of expansion has become less swift. The Company today is very much in the situation in which some of the assessment insurance or beneficial orders were for a number of years after they began business. New members were taken in, in large numbers and at relatively low ages. The average mortality was small, and the assessments low. In the course of time, when recruits no longer bore so large a proportion to the veteran members, it was found that the number of deaths and the amount of assessments rose, often to figures disastrously high."

It is true that in that case the Court also followed the practice established by the Commission of deducting the reserve, holding in effect that under all the facts and circumstances of the case it might fairly be taken to represent the property depreciation to be deducted in valuing the property. The Court below in the case at bar has done the same thing.[18]

The circumstance that the reserve increased to the extent stated in 1933 is without special significance and clearly is no justification for the Commission's action in reducing the item for 1934. The history of the reserve of this Company, above shown, demonstrates this. Moreover, in accordance with the principles of straight-line depreciation accounting, it was to be expected that normally the reserve would increase when expansion and the new construction incident to it were interrupted by the depression. It is in the nature of the straight-line method that, other factors remaining the same, the reserve should go up under these conditions.

[18] In the former case the Court trended the reserve, since it was invested in the plant, to conform to reproduction cost new and deducted the larger amount. Here no trending was necessary.

The District Court stated its conclusion as follows:

> "Looking at the evidence as a whole we conclude that the Company has underestimated, while the Commission has over estimated, the effect fairly attributable to the Company's temporary partial loss of business in the past two years. As the proper depreciation allowance for the near future is, under the conditions now existing, necessarily an estimate only, it is obviously not susceptible of mathematical demonstration but should be the result of a reasonable judgment on consideration of all revelant facts. In our opinion the depreciation allowance at the percentage rate of 4% on the book cost of the plant now in service is reasonable and proper for the ensuing year. On this basis the allowance should be $2,000,000. The Company's estimate of net revenue for 1934 must therefore be adjusted by the addition of $173,000 thus making the estimated net revenue for 1934 $2,742,005." (Opinion, I, 578; 7 F. Supp. 236).

The finding of the District Court should be sustained.

VII.

RATE OF RETURN.

The fair rate of return claimed by the Company, and supported by the testimony of its witnesses, was 7½%. (Bill of Complaint, par. X, I, 6; testimony, I, 353-372.) The rate adopted by the Commission in its opinion was 6% (I, 17, 75, 76, 77; See Note below). In the answer to the bill of complaint below (par. X, I, 91) the Commission, while denying the Company's claim of 7½%, refer to their own opinion for their reasons for such denial. In the argument and brief for the Commission below, it was, as stated in the Court's opinion (I, 580, 7 Fed. Supp. 237), conceded that 5½% was the limit of

confiscation. The Court in its findings (I, 585) and opinion (I, p. 580), determined 6% as the present fair rate of return.[18]

Principles Determining Fair Rate of Return.

Although "the question of the minimum of a fair percentage on value is shown to vary with the circumstances" (*Dayton-Goose Creek Railway v. U. S.*, 263 U. S. 456, 486), and therefore depends upon the facts as shown by the evidence in each particular case, yet the decisions of this Court have made clear some of the guiding and controlling principles in making such determinations.

In *Bluefield Company v. Public Service Commission*, 262 U. S. 679, 692-693, it was said:

> "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. *The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to main-*

[18] On page 151 of the Commission's Brief there is a quotation from the Commission's opinion in support of the proposition that the Commission indicated that the rate of return so found by it "could properly have been lower." Reference to the passage in the Commission's opinion quoted (I, 75) will show that what the Commission said was that the rate of return allowed by it "is fair and reasonable for this Company".

tain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." (Italics ours.)

And in *United Railways & Electric Co. v. West*, 280 U. S. 234, 251, the following statement was made:

> "It is manifest that just compensation for a utility, requiring for efficient public service skillful and prudent management as well as use of the plant, and whose rates are subject to public regulation, is more than current interest on mere investment. Sound business management requires that after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and a rate of return which does not admit of that being done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to raise money necessary for the proper discharge of its public duties. In this view of the matter, a return of 6.26 per cent. is clearly inadequate. In the light of recent decisions of this Court and other Federal decisions, it is not certain that rates securing a return of 7½ per cent. or even 8 per cent. on the value of the property would not be necessary to avoid confiscation."

Justice Brandeis in his dissenting opinion in *Southwestern Telephone Co. v. Public Service Commission*, 262 U. S. 276, 290-291, says:

> "The investor agrees, by embarking capital in a utility, that its charges to the public shall be reasonable. * * * The compensation which the Constitution guarantees an opportunity to earn, is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance by way of interest, for the use of the capital, whatever

the nature of the security issued therefor; the allowance for risk incurred, and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more."

The *rationale* which underlies the determination of a fair rate of return, is one that includes two considerations, viz., that the investors in the utility are protected against having their return cut below the returns which are generally being made in comparable businesses and undertakings; and that the Company is also entitled to have its return not cut below such a rate as is necessary to enable it to raise the additional capital which it may require from time to time for its operations and for the natural growth of its undertaking.

The second consideration is one which has especial force with respect to the undertaking of the Telephone Company as is apparent by referring to the curve or graph of the Company's growth in stations or subscribers since 1910 which was filed by the Commission's witness Mr. Pagon (II, 1090A; I, 501). This graph shows an almost straight line rate of growth or increase from 1910 to the end of 1931; followed by a falling off during 1932 and 1933, but a rise beginning in the latter part of 1933; which the evidence showed was continuing in 1934. Manifestly therefore we have the case of a company which in the past has had a constant need for additional capital and as to which indications are that such growth will continue in the future.

The argument that this constant growth in the business of the Company indicates a stability such that its business can be regarded as one free from risks, and will be so regarded by investors, and that there is a practical certainty that all of the money which is being poured into

it will finally be returned to the investors (with usury), is not one that is supported by historical considerations. The history of electric railway enterprises, for instance, illustrates the fact that public utilities which seemed to enjoy the greatest certainty of continued earnings and prosperity were subject to contingencies which no one could foresee, but which have operated disastrously in what was then the not very distant future. And railroads, to a less degree, illustrate the same uncertainty which underlies even what seemed to be one of the most stable forms of investment.

Evidence on Rate of Return.

The evidence offered by the Commission on this subject was confined to the net rate of return upon *bonds* recently sold by public utilities (II, 896-97), on which they figure a "weighted average yield" of 5.61%, and a tabulation classifying corporations of all kinds according to whether they had sustained losses in their operating incomes for the year 1932 or earned a percentage varying from 1% up to 228% on their plant and inventories (II, 897-910), and similarly classifying railroad corporations under like heads.

The witnesses who testified for the Company on this subject included Mr. Crunden, the Assistant Comptroller of the American Telephone and Telegraph Company, and Messrs. Prentis and Boyce, two bankers of wide experience in investments, in Baltimore City (I, 353-372).

They testified that a fair rate of return of not less than 7½% on the fair value of the Company's property would be needed to maintain confidence of investors and enable it to secure capital at rates that would be fair to the existing owners, for the purposes of the utility. The answer

which Mr. Crunden gave on cross-examination to the question whether or not a return of 7½% in normal times should not be considered equivalent to a return of 6% in times such as the present, is perhaps especially in point on the present appeal:

> "I would not say that if a public utility like this ought to have a return of 7½% on its sound value in normal times, that a return of 6% in times of adversity would be about reasonable—not under the practical conditions of regulation, because as soon as the Company went through the other half of the business cycle and tried to recoup the loss of 1½% for the period involved; and they might have several years of depression;—it could be met generally with a demand for reduced rates, and it never would be able to get an average of 7½%, and the result would be it would have 6% during part of the time and 7½% the remainder of the time." (I, 367).

Effect of Depression on Fair Rate of Return.

This part of Mr. Crunden's testimony which we have quoted is addressed to what is perhaps the crucial point in reference to rate of return in the present case; viz., what effect should the existence of the depression in business, which the country is now undergoing have upon the minimum rate of return, reduction below which would constitute confiscation.

On the one hand the arguments and evidence produced on behalf of the Commission would seem to prove, if they prove anything, that a utility should be reduced to a rate of return commensurate with that of the average business or enterprise generally; and this without regard to the fact that the regulation of the public utility necessarily presupposes or involves a greater stability in return; because it is not permitted to earn large profits during prosperous times, which compensate other busi-

ness enterprises for their losses or diminished returns during depressions. The confidence of investors will not be invited by regulation which limits a utility to a fair return in prosperous times, and then cuts it down (in addition to the losses due to its own shrinkage in business) to a much lower figure in times of depression.

Nor (as the evidence abundantly shows) is the present period of depression one in which funds for permanent investment in utility enterprises are forthcoming at low rates. Short time loans on ample security can undoubtedly now be obtained at a very low rate of interest. This, however, is not the form of investment which the theory of fair rate of return contemplates; and the return which may possibly be realized by buying the stock of business corporations which are now earning a vastly diminished return, or none at all, does not represent the rate at which money for such enterprises will be now advanced by investors; because the shares of such companies are selling at greatly diminished prices. The question therefore is one of the rate at which new capital can be secured from investors upon terms which will put such new investors on a basis equivalent to that of the existing owners of the property.

It is true that such calculations of the rate of return which will attract investors must necessarily have reference to the future as well as to the existing period of depression in business; in other words a utility may be expected to earn less money during the temporary period of depression than the average of its earnings over any considerable period of time; and the question therefore presents itself from the investor's standpoint as one of profitable earnings over a period of longer duration than the immediate present.

It should be noted in this connection that the Company had already incurred a loss in net revenue, over what it

made in 1931, of 23% (Court's Opinion, I, 530; 7 Fed. Supp. 217). The Company has sought no increase in rates on account of this loss due to the shrinkage in its own operations; it is the Commission that is seeking to impose upon it a further reduction or loss of about 40%, upon the theory the Company ought to undergo a greater shrinkage than it has actually suffered in its business on account of the depression and of the fact that the earnings of corporations generally have shrunk to a larger amount. The combined effect of these two reductions is nearly 50% from the net return in 1931, (I, 530; 7 F. Supp. 217).

We think that this distinction is the essential one in considering what reduction in rate of return a utility may be subjected to, during a time of depression, and on the assumption that the depression is temporary and that the business of the utility will improve and be better in the future. Assuming that the utility was not making an excessive rate of return prior to the depression, we submit that the shrinkage in revenue due to the depression itself, as operating upon a business of the character of that conducted by the Company, should be the maximum limit of any reduction in its rate of return which the Company should be required to submit to, during the time of depression, because of the depression. In other words, the Company should be entitled to the benefit of the fact that its business is of a more stable character than that of business corporations whose losses have been very much greater; and it is this very stability that is taken into consideration in limiting the rate of return of a public utility, or regulated corporation, during prosperous as well as unprosperous times.

Some figures which were given by Mr. Gretz, the Company's Accountant, at the request of counsel for the Commission in the hearing below, help to throw light upon

these considerations. They give the rate of return over a period of years upon cost or book value, without allowance for working capital or going value (except to the extent that going value may be considered to be included in cost, as found by the court below). The first column in the table which we are giving is taken from Ex. A-5 and Ex. A-6, (I, 611, 613) while the second column of figures includes those which were given by Mr. Gretz at the request of counsel for the Commission in its testimony (I, 212).

	Ratio of Net Earnings to:	
Year	*Average Plant*	*Average Plant Less Depreciation Reserve*
1924	4.71%	5.93%
1925	6.36%	7.81%
1926	6.98%	8.43%
1927	6.08%	7.40%
1928	6.62%	8.09%
1929	6.71%	8.29%
1930	6.54%	8.10%
1931	6.85%	8.41%
1932	5.78%	7.10%
1933	5.15%	6.47%

The foregoing table therefore shows in an approximate form the rate of return the Company was receiving during the period antedating the depression; and the effect which the depression has already had in reducing that rate to a much lower level.

Evidence of Cost of Raising Capital to Company and to American Telephone and Telegraph Company.

While the evidence indicates that the interest rate upon relatively short time loans with ample security has decreased as one result of the business depression, there is

no indication of any similar decrease in the return necessary to attract long time or permanent investments of capital in even the soundest of public service corporations upon terms which do not discriminate against the existing owners. On the contrary, the testimony of all three of the witnesses who testified upon this subject (Crunden, Prentis and Boyce, I, 353-372) is to the effect that greater inducements will be needed to attract capital now than during prosperous times.

As, with the exception of the $3,000,000 of 7% preferred stock which it has outstanding, the Company's needs for additional capital have been supplied by its parent company, the A. T. and T. Co., and by issue of common stock from time to time to take up such advances, there have been no sales of common stock of the Appellee, nor has it issued any bonds.

But the cost of capital to the A. T. and T. Co., and the rates at which bonds have been issued by other Bell Companies, are relevant to the present subject of inquiry.

Exhibit A-41 (II, 795) gives the average cost of its capital, in the form of interest and dividend payments thereon, to the A. T. and T. Co., showing an overall average of 6.59%. This exhibit is more fully explained in the testimony of Mr. Crunden (I, 354-359); who testified (I, 358) that the figure of 7.87% representing the return of the stockholders upon the paid-in amount of the capital stock, (which was issued at a premium) represented rather the cost of money raised during more prosperous times; and that if they wanted to issue any considerable amount of stock today, they would have to sell it on a better basis to the purchaser than a return of 7.87%, to secure a price equal to the par and premium paid for the stock now outstanding.

Exhibit A-42 (II, 796) is a statement showing the cost of money raised by the issue of bonds by the Asso-

ciated Companies of the Bell System during the ten year period from 1922 to 1931. This shows the cost to the Company issuing the bonds ranging from 5.02% to 5.70%; and represents, of course, only the cost of money raised by giving to the lender a first lien upon the Company's property. As already explained, it does not represent the cost of raising money upon equal terms of security with the existing owners of the stock.

The uncontradicted evidence clearly establishes, it is submitted, that neither in more prosperous times nor in the existing depression, could the Company raise capital upon terms which do not postpone the existing investment (whether taken at cost or on fair present value) to prior rights of the contributors of such new capital.

Comparison With Other Bell Companies.

The Commission argues (p. 154) that this Company is among the most successful, from an earnings standpoint, of all the wholly owned Bell Telephone Companies operating where public regulation obtains, and state that it would be hard to frame a more attractive proposition to a prospective customer. In support of this contention, they refer to a table included in Exhibit D-12 (II, 918), showing comparative earnings for Bell System Companies for one year only (1932), ranging from 2.43% to 6.19% with an average of 4.43% on gross cost, and from 2.92% to 8.2% with an average of 5.52% on cost less depreciation reserve.

Inasmuch as investors look to more than one year, it is submitted that Commission's proof is lacking in confining their comparison to a single year, especially in view of the fortunate position of this Company during the first two years of the depression.

While the depression is generally understood to have started in the latter part of 1929 (the Commission's Brief

refers to four years of the worst depression in history), this Company was fortunate in showing substantial growth in stations for the years 1930 and 1931 with corresponding gains in gross revenue (Exhibit A-5; I, 611). Loss in stations and revenue as far as this Company was concerned began in 1932 and continued through 1933 (Exhibits A-5 and A-6; I, 611-613). The comparison sought to be made is therefore between the returns of this Company and the returns of other Bell System Companies selecting a year which is not comparable.[20]

On the basis of the present rates, this Company earned in 1932, according to the table, 5.67% on gross cost and 7.13% on cost less depreciation reserve. Under the Commission's Order reducing operating income by $1,000,000, this Company would have earned 3.67% on gross cost and 4.61% on cost less depreciation.

Commission's Contention That Net Return Should Be Reduced in Proportion to Any Increase in the Value of the Dollar in Terms of General Commodities.

This argument presupposes the valuation of the Company's property in present day dollars and sets up the claim that fair return upon such property valued in dollars should be reduced to correspond with the supposed increased purchasing power of the dollar as applicable to such commodities and purposes as the investors for whose ultimate account the fair return may be supposed to be received, may be expected to apply their income to; or as the brief expresses (p. 163) to represent "real income". In other words a return upon a value determined in dollars is first to be ascertained; and then such return translated to a basis lower than that on which

[20] The Court noted a decline in revenues of the Bell System Companies of approximately 35% from 1929 to 1932, (I, 563, note; 7 F. Supp. 230). The decline in revenues of this Company during the same period was less than 2½%. (Exhibit A-5; I, 611).

the property itself is valued, for the purpose of allowing to the investors only the "real income" to which they are supposed, as a matter of social justice, to be entitled.

Manifestly this involves the application of a double standard: one to be used in ascertaining the value of the property used in the public service; and a lower standard into which the rate is to be translated.

Commission's Contention That Rates Should Be Reduced Because the Income of the Average Telephone Subscriber Has Been Reduced.

This again is another appeal to a supposed principle of social justice. There is no suggestion in the evidence in the present case that telephone service is not worth all that it costs; and if the cost of furnishing it were much greater than it is, it would still be fully worth its cost. The suggestion that rates should be reduced below cost, including a fair return, in order to meet the needs of those whose income has been reduced, might well (whether wisely or not) be an argument for reducing rates if telephone service were furnished by, and at the expense of the government, or the taxpayers. Whether the public would be better served if such were the case (and comparisons between telephone service in this country and in countries where it is a function of the Government lend no support to such a contention), is not the question here; and still less is the Court concerned, under the existing system of laws and property, and of constitutional rights, with the question whether or not social justice requires that the owner of property, though employed in serving the public, should serve the public at rates which do not yield a fair and adequate return, upon the ground that the diminished income of many of its customers should entitle them to receive service at rates which will not yield a fair return to the owners of the property in question.

CONCLUSION.

In conclusion, it is respectfully submitted that the District Court decided this case upon correct principles of law, that its findings of fact are fully sustained by the evidence, and that the decree appealed from should therefore be affirmed.

CHARLES McH. HOWARD,
RAYMOND S. WILLIAMS,
R. A. VAN ORSDEL,
T. BAXTER MILNE,
Counsel for Appellee.

S. [redacted] BRACELEN,
JOHN H. RAY,
Of Counsel.

April 6, 1935.

APPENDIX.

Counsel for the Commission have offered, in the form of an appendix to their brief, from the Company's annual report for 1934, the results of its operations for that year, which were of course before the Court below only in the form of estimates for the year made not later than March when the evidence below was offered. The results shown confirm with considerable accuracy the estimates or predictions upon which the lower Court based its findings.

> "In assuming that it is our duty to deal with the case as it is disclosed by the record, counsel are clearly right. A like obligation rests upon counsel."
>
> *Chapman v. St. Francis Levee Dist.*, 234 U. S. 667, 668.

Bearing this admonition in mind, yet as Counsel for the other side now offer this additional evidence, it is at least permissible for us to call attention to what it shows, and to other facts affecting the conclusions sought to be deduced therefrom, in case this Court should for any reason consider that such matters outside of the record should be given consideration.

Both the estimates of revenue for the year and the estimate of growth in stations, were slightly exceeded. The *estimated* net operating income was $2,569,005. (II, p. 797), that realized $2,644,437., an excess of $75,432. The *estimated* growth in stations was 5,000 (II, p. 797) that which actually resulted 5,871, an excess of 871. Both of these realizations are important in connection with the argument advanced for the Commission with respect to depreciation expense;—that a permanent cessation of growth has occurred; and that the point of telephone "saturation" has been attained.

In connection with the excess of allowances for depreciation during the year over actual retirements, of about one million dollars, the following facts should also be taken into account, if facts not in the record and provable only after the decision below are to be considered. In January, 1935, immediately after the close of the year 1934, a heavy sleet storm on the Eastern Shore and in Southern Maryland caused very extensive damage to the property of the Company, sufficient to wipe out nearly all of the apparent gain to the depreciation reserve in 1934. We are subjoining a statement of this loss to the depreciation reserve resulting from this cause (which is one of those for which accruals to the reserve are made) which is of course no part of the record in this case, but is not so to any greater extent than the annual report sought to be introduced by the Commission, and should in fairness be considered with it, if any consideration can or should be given to either.

In the appendix to Commission's brief, the concluding argument is made that the fact that the Company was able, in 1933 and 1934, to reduce its "long term indebtedness" to its parent company by substantial amounts, shows that such payments were "made out of its subscribers through excess rates", and "conclusively taints and discredits the Company's position before this Court".

The fact that its indebtedness was so reduced of course has no tendency to sustain either of these propositions. Such cash not being required for the immediate needs of the Company, the prudent thing to do with it was to reduce the interest bearing indebtedness of the Company to the A. T. and T. Company, from which it could again be obtained at the same interest rate any time in the future when required for the purposes of the Company.

We are also including in this appendix a graph of the All Commodities Index of Prices, which are compiled and

published by the U. S. Bureau of Labor Statistics, brought up to the latest available date, and referred to in our brief at pp. 45, 47. As there stated, these price indices are within the judicial notice of this Court, though of course the latest part of the graph was not available to the Court below when it made its decision.

1. Statement of charges against the Depreciation Reserve Account as a result of the storm of January 23, 1935.
2. Graph of All Commodities Index up to February, 1935.
3. Summary tabulation of amounts found by the Commission, the corresponding amounts in the evidence of the Company and the comparable amounts found by the District Court.

The Chesapeake and Potomac Telephone Company of Baltimore City

Authorization—Estimate No. 543

Title: Maryland—Repairs to Outside Plant Due to Sleet, Snow and Wind Storm of January 23, 1935.

Analysis of estimated charges against the Depreciation Reserve:

Plant Displaced	$774,800
Cost of Removing	71,390
	$846,190
Salvage	120,250
	$725,940

This estimate provides for the work necessary to repair and restore the outside plant in the southern and eastern sections of Maryland which was damaged by the sleet and snow storm of January 23, 1935.

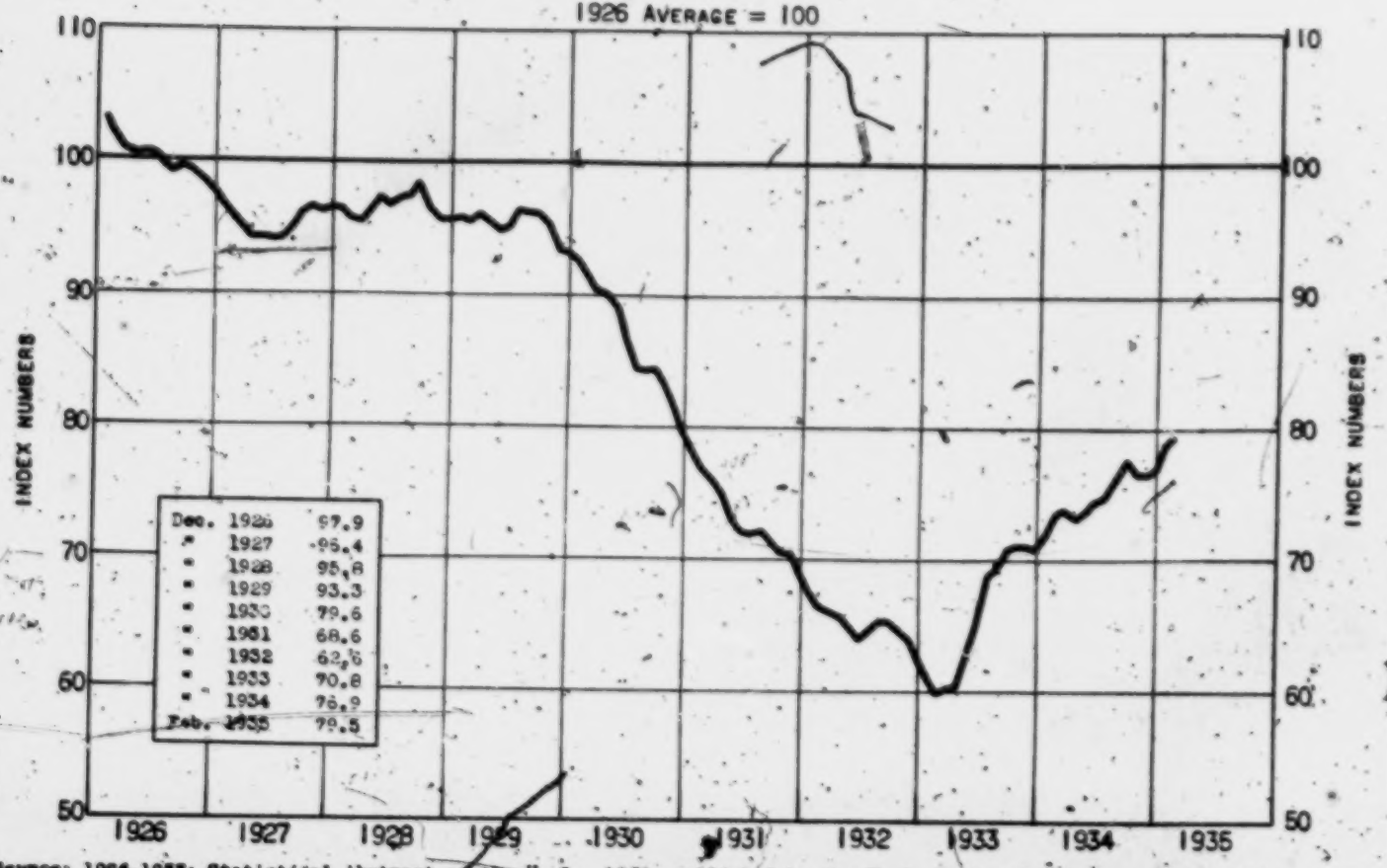
Approximately 4,000 poles and 2,500 single miles of wire were damaged or destroyed, interrupting service on 724 lines, 3,584 stations and 260 toll trunks.

Authorization approved by the Board of Directors, February 25, 1935.

(S) Harry C. Gretz,
General Auditor.

ALL COMMODITIES INDEX
OF THE UNITED STATES BUREAU OF LABOR STATISTICS
(784 PRICE SERIES)

1926 AVERAGE = 100



Source: 1926-1933: Statistical Abstract of the U. S., 1934, published by the U. S. Dept. of Commerce. (Table 314, Page 283)
1934: Wholesale Prices, December and year 1934, Serial No. R,205, U. S. Bureau of Labor Statistics.
January and February 1935: Wholesale Prices in February 1935, No. 1595, U. S. Bureau of Labor Statistics.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF BALTIMORE CITY

SUMMARY TABULATION OF FIGURES

TOTAL PROPERTY

		Commission's Findings	*Company's Evidence* Cost	*Company's Evidence* Reprod. Cost	*District Court's Findings*
	December 31, 1932	(I, 56, 69)	(II, 798)	(II, 798)	
1.	Physical Property, Undepreciated	39,059,155	49,991,946	48,211,121	
2.	Going Value	(I, 69) 731,762		4,500,000	
3.	Working Capital	737,000	1,615,000	1,615,000	
4.	Total, Undepreciated	40,527,917	51,606,946	54,326,121	
5.	Deduction for Depreciation	7,318,086		6,360,002	
6.	Total, Depreciated	33,209,831		47,966,119	
	December 31, 1933		(II, 798)	(II, 798)	
7.	Physical Property, Undepreciated		50,025,278	49,031,267	
8.	Going Value			4,500,000	50,025,278 (I, 550)
9.	Working Capital		1,615,000	1,615,000	1,000,000 (I, 584)
10.	Total, Undepreciated		51,640,278	55,146,267	51,025,278
11.	Deduction for Depreciation			6,723,451	11,483,357 (I, 534)
12.	Total, Depreciated	Several, ranging from 30,753,626 to 41,036,789 (Note 1)		48,422,816	39,541,921 (I, 584)

NOTE 1. Commission's evidence of Fair Value or Rate Base in the case before the District Court consisted of a computation of values (exclusive of Working Capital) as of December 31, 1933, by the various index numbers and ranging from $30,753,626 to $41,036,789 (II, 871). No weighted average was given even though the Commission, in its opinion, did develop and use a weighted index.

REVENUES, EXPENSES AND NET RETURN—TOTAL OPERATIONS.

		Commission's Findings Depreciation on Cost	*Commission's Findings* Depreciation on Value	*Company's Evidence* Depreciation on Cost		*District Court's Findings*
			Estimated	*Estimated*	*Actual*	
	Year 1933		(I, 76)	(I, 76)	(II, 797)	
1.	Total Telephone Revenues		12,248,000	12,248,000	12,426,618	
2.	Depreciation Expense		1,352,284	2,159,000	2,166,211	
3.	Taxes		1,623,923	1,513,000	1,624,934	
4.	Other Expenses		5,918,000	5,918,000	6,107,512	
5.	Total Telephone Expenses		8,894,207	9,590,000	9,896,657	
6.	Net Telephone Revenues		3,353,793	2,658,000	2,527,961	
	Year 1934 (*Estimated*)	(II, 921)	(II, 921)	(II, 797)		(I, 578)
7.	Total Telephone Revenues	12,700,250	12,700,250	12,700,250		12,700,250
8.	Depreciation Expense	1,720,724	1,352,284	2,173,000		2,300,000
9.	Taxes	1,620,433	1,671,093	1,558,245		1,558,245
10.	Other Expenses	6,400,000	6,400,000	6,400,000		6,400,000
11.	Total Telephone Expenses	9,741,157	9,423,377	10,131,245		9,958,245
12.	Net Telephone Revenues	2,959,093	3,276,873	2,569,005		2,742,005